



United States  
Department of  
Agriculture

Forest  
Service

Agriculture  
Handbook  
No. 708

# Forest Owners' Guide to the Federal Income Tax

Form T (Timber) (Rev. 4-95)  
**Schedule E Reforestation an**

26 Summarize your expenses for reforestation activities on this schedule. Keep support the costs reported in this available if your return is examin expenses such as supplies, labo tools, and depreciation on equi Site preparation.—Report all e tax year for preparing the land (including natural seeding). Incl land of brush and cull trees by shearing and piling, spraying, and measures taken to aid success; separately for each depletion; operating area tributary to a n contract work separately from

Account, block, tract,

Total.  
**Schedule F Capital Re**

On lines 27 through 42, giv separately. Cover any char tax year. Attach as many 2 needed. If you deplete on

27 Name of block and title

28 Estimated quantity of end of the immediate

29 Increase or decrease

30a Addition for growth (p

b Transfers from defen

c Transfers from defen

31 Timber acquired dur

32 Addition to capital c

33 Total at end of year

34 Unit rate returnabl (b), divided by line

35 Quantity of timber

36 Depletion sustain

37 Quantity of stand

38 Allowable as bas

39 Quantity of stanc

40 Allowable basis

41 Total reductions

a Add line 35, col

b Add line 36, co

42 Net quantity at and line 33, cc

<sup>1</sup> MBF, log scale.  
<sup>2</sup> Adjust the quant losses, recourc a change, clearl  
<sup>3</sup> Analyze the add expenditures at

43 Quantity of

Form T (Timber) (Rev. 4-95)  
**Schedule C Profit or Loss From L**

14a Purchaser's name and address

15 Amount received: a In cash . . . . .  
b In interest-bea . . . . .  
c In non-interest

16 Amount received in other consid

17 Explain the nature of other consid on line 16

18 Total amount received for property

19 Cost or other basis of property:

a Forested land

b Nonforested land

c Improved land (describe)

d Merchantable timber (Estimate quantity of merchantable timber sale or exchange. Include the in each species of timber by c height (DBH) classes. State th unit of measure in thousa (MBF, log scale.)

e Premerchantable timber

f Improvements (list separ

g Mineral rights

h Total cost or other ba

i Direct sale expenses

20 Profit or loss (line 18

**Schedule D Loss**

21 If you had losses d, show separately th

22 Cause of loss

23 Location and area

24a Total loss before

b Less amount rec

c Loss as claimed

25 Explain in detail

Form T (Timber)

(Rev. April 1995)

Department of the Treasury  
Internal Revenue Service

Name(s) as shown on return

**Forest Activities Schedules**

► Attach to your tax return.

For tax year ended . . . . . 19 . . . . .

OMB No. 1545-0007

Attachment  
Sequence No. 89

Identifying number

**Paperwork Reduction Act Notice**

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us with these laws and to allow us to figure and collect the right amount of tax.

The time needed to complete and file this form will vary time is:

Recording . . . . . 37 hr., 4 min.  
Learning about the law or the form . . . . . 35 min.

Preparing and sending the form to the IRS . . . . . 1 hr., 14 min.  
If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the IRS. See the instructions for the tax return with which this form is filed.

**General Instructions**

Section references are to the Internal Revenue Code unless otherwise noted.

**Who must file.**—If you claim a deduction for depletion of timber accounts, or elect under section 631(a) to treat the cutting of timber as a sale or exchange, you must complete and file Form T when you sell or cut standing timber or are involved in other timber transactions.

Complete Form T in accordance with sections 611, 631, and 1231 and related regulations. **Complete only Schedules C and F activity during the year was an isolated sale of timber.**

**Overview of form.**—Form T has nine schedules. Use the following rules to determine which schedules to complete.

**Schedule A (optional).**—If you do not send the Schedule A return is examined.

**Schedule B.**—Complete for any year you acquire timber cutting contracts, or forest land. Complete Schedule B

**Schedule A Maps (Optional)**

1 This schedule consists of a map (or maps) of your timber properties. Whether you file the maps with your income tax return is your option, but you must make them available if your return is examined. Maps of convenient size are desirable, varying in scale from approximately 4 inches to the mile in small tracts to 1/2 inch to the mile in tracts larger than 200,000 acres. The maps should show your name and the tax year. Give standard map symbols in

**Schedule B Acquisitions**

2 Report acquisitions during the tax year (such as by purchase, exchange (whether taxable or not), gift, or inheritance) of timber, timber cutting contracts, or forest land. Report separately each acquisition of \$10,000 or more. You may combine acquisitions of less than \$10,000 for each account, and omit lines 4 and 5. For an acquisition by gift or inheritance, do not complete line 6 through 8b. For an acquisition or lease of timber-cutting rights on a

3 Name of block and title of account<sup>1</sup>

4 Location of property (by legal subdivisions or map surveys)

5 pay-as-cut basis, except for those under which all cutting is completed within the tax year, do not complete lines 6 through 10. Instead, briefly give the provisions of the purchase or lease agreement, including the number of years from the effective date to the expiration date, annual minimum cut or payment, and the payment rates for different kinds of timber and forest products. Follow the format of lines 3 through 10 on additional sheets if necessary.

<sup>1</sup> You must include your timber in one or more accounts. Generally, each account must include all your timber that is located in one "block." A block may be removed by a single logging development, or (c) an area established by the geographical or political boundaries of logical management areas. Timber acquired under a cutting contract may not be included in part of a block, but should be kept in separate accounts. For exceptional cases, the timber in a given block may be divided into two or more accounts. See Regulations section 1.611-3(d) for more information.

whether the acquisition is a purchase, exchange, gift, or inheritance.

**Schedule C.**—Complete for any year you sell or exchange timber, timber cutting contracts, or forest land.

**Schedule D.**—Complete if you claim a loss on your income tax return for timber lost due to fire, wind, theft, or other causes.

**Schedule E.**—Complete only if you pay or incur expenses for reforestation of forest land or for timber stand activities. Examples of reforestation expenses are costs for site preparation and for planting or seeding. Examples of timber stand activities are precommercial thinning and fertilization.

**Schedule F.**—Complete for each timber account that has changed in quantity or dollar amount. A timber account may be a quantity or dollar amount as a result of acquisitions, dispositions, the cutting of timber, capitalized expenditures, transfers from other accounts, corrections, additions for growth, and depletion for timber cut or the basis for timber sold or lost during the tax year. Also use Schedule F if you treat the cutting of timber as a sale or exchange under section 631(a).

**Schedule G.**—Complete to show changes in ownership of land during the tax year.

**Schedule H (optional).**—Complete if you incur expenses for building of logging truck roads. If a timber company builds the road but later charges the landowner for the cost, the landowner should complete Schedule H.

**Schedule I (optional).**—Complete if you incur expenses for building drainage structures, such as ditches.

For more information about Federal income tax rules and recordkeeping for forestry activities, see *Agriculture Handbook No. 691, Forest Owners' Guide To Timber Investments, The Federal Income Tax, and Tax Recordkeeping*. To order this handbook, call 202-512-1800 (not a toll-free number) or write the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402. The handbook costs \$7.00 (subject to change); its GPO stock number is 001-000-04540-7.

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# Forest Owners' Guide to the Federal Income Tax

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improvement.

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## Abstract

Siegel, William C.; Hoover, William L.; Haney, Harry L. Jr.; and Liu, Karen. 1995. *Forest Owners' Guide to the Federal Income Tax*. Agriculture Handbook 708. Washington, DC: U.S. Department of Agriculture. 138 p.

Updates and expands Agriculture Handbook No. 681, "Forest Owners' Guide to Timber Investments, the Federal Income Tax, and Tax Recordkeeping." Incorporates changes made since the 1987 Revenue Act. Provides a framework for analysis of timber investments and a chapter on timber tax planning. Discusses Federal income tax considerations for timber including: capital costs, reforestation tax incentives,

depreciation, operating expenses and the passive loss rules, timber income and capital gains, government cost-share payments, casualty losses and other involuntary conversions, conservation easements, installment sales, the alternative minimum tax, self employment taxes, Christmas tree production, and form of timberland ownership and business organization. Explains how to research tax questions, sources of tax assistance, and how to keep forest records. Provides summaries of selected revenue rulings. Blank tax and record forms, a glossary, and a comprehensive findings index are also included.

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## Chapter I. Introduction

### Purpose

The purpose of this handbook is to encourage good forest management by presenting methods of analyzing forestry investments, and by explaining the Federal income tax as it pertains to timber and timber transactions. It also provides a system and blank forms to enable you to keep the necessary records for tax purposes and to assist you in more effectively managing your timber investment. This publication is a major revision of Agriculture Handbook 681, *Forest Owners' Guide to Timber Investments, the Federal Income Tax, and Tax Recordkeeping*. It updates the previous publication for changes made by legislation passed after the 1987 Revenue Act, and for administrative changes promulgated through 1994.

Since there is once again a differential in tax rates on long-term capital gains and ordinary income for certain noncorporate taxpayers, the section on timber capital gains has been revised. The passive loss section has also been modified to reflect recent administrative developments. New chapters on Christmas tree taxation, tax implications of forest stewardship, and forms of business organization and ownership have been added. There are new sections on the income tax aspects of the employee-employer-independent contractor relationship, information returns, and costs of sale. The social security/self-employment tax section has been updated. As with the previous edition, there is a chapter on timber investments, in order to place timber income tax considerations in perspective with the total forestry investment.

The primary purpose of the handbook is to provide in one place the relevant information for analyzing a timber investment and the Federal income tax law associated with the investment. It does not provide guidance in establishing or managing a forest stand. That information is available from State forestry agencies, the USDA Cooperative Extension System, private forestry consultants, and industry foresters.

Good records are necessary for both effectively managing a timber enterprise and reporting income and expenses for tax

purposes. Therefore, the section on recordkeeping has been retained to show how to record timber-related transactions. Forms are provided for recording expenses and income.

The chapter on researching tax questions is intended to assist you or your tax advisor in understanding the relationship between statutory and administrative law. Audit and appeal procedures and how you take your case to court if you disagree with the Internal Revenue Service (IRS) are explained. A comprehensive example explains tax research procedures. Appendix I summarizes pertinent revenue rulings dealing with timber. Appendix II provides a detailed index and findings list for researching tax questions. Appendix III provides a tax form relevant to timber transactions. Appendix IV provides forms for recording your timber transactions.

### Sources of Assistance

Chapter XIII lists sources of tax assistance. Local offices of the Internal Revenue Service can supply taxpayer publications to answer most questions you will have about income taxes. Foresters can provide assistance in determining timber values, establishing volumes, and developing management plans. You may wish to consult an accountant or attorney for the application of the law to your particular facts and circumstances, especially when the dollar amounts involved are large or there is a particular tax problem.

### Internal Revenue Service Review

This publication has been reviewed by the Internal Revenue Service, principally by its timber tax law specialist. It is not, however, to be construed as an official interpretation of the Internal Revenue Code or income tax regulations. It is intended to serve only as a guide for you and your tax advisor. Although the information in this publication is based on current law and regulations, many aspects of newer law are under review by the IRS, and new regulations will be published as appropriate. You should consult the most current information for your individual case as outlined in Chapter XII, "Researching a Tax Question." The information in this publication is current as of January 1995.

## Chapter II. Timber Investment Considerations

Is forestry a good investment? Most forest landowners would like to think so. Generally, growing timber can be a profitable enterprise; however, the final answer depends on the facts and circumstances in each case. The rewards from a forestry investment often involve more than financial returns, including the satisfaction of ownership and a sense of pride from good stewardship of the resource. Such intangible benefits, which do not show up on the balance sheet as additional revenue, may help explain why owners are willing to hold timber properties that are not competitive financially. It is assumed in this chapter that you are interested in the economic returns associated with forestry management. Its purpose is to describe objective methods of evaluating forestry investment opportunities on your property. These methods will be illustrated for a managed loblolly pine stand typical of the Southeastern United States.

### Characteristics of a Timber Investment

Timber is a unique investment with several characteristics that are not typical of normal business situations. First, and most conspicuous, is the long growth (investment) period. Natural stands of southern pine frequently require an investment length of 45 to 60 years from seed to harvest, a period known as the rotation. Eastern hardwoods may need 60 to 80 years to produce quality sawtimber products. Many western species also require long rotations when managed in natural stands. On the other hand, intensive management of planted southern pine shortens the investment horizon to approximately 25 to 35 years depending on site productivity, cultural practices, and markets. Similarly, investments in intensive management shorten the rotation for hardwoods, mixed pine-hardwoods and western conifers; however, the investment length is still long. Energy (fuelwood) plantations, which have projected harvest cycles of 5 to 15 years, and Christmas trees, which typically range from 4 to 12 years in age at harvest, are exceptions. These opportunities are regionally important, but account for only a relatively small share of the country's overall forest potential.

The forest resource produces many benefits in addition to wood products. Among the multiple outputs that accrue to woodland landowners are wildlife—both game and nongame species—natural beauty, outdoor recreation, and quality water. With the exception of hunting leases, owners rarely receive monetary returns from these outputs.

The harvest timing for timber products is more flexible than that of annual crops. A harvest schedule can be accelerated or postponed by several years, in most cases, and this gives the timber owner the opportunity to coincide the harvest with personal income needs, or to wait for a more favorable price situation. Timber owners can plan to sell different products—including firewood, pulpwood, chip-n-saw, sawtimber, and veneer logs—depending on market conditions and price relationships. Within limits, and with patience, timberland can

be acquired in sizes to meet the needs of most investors. Purchases can range from a few acres to thousands of acres, with timber age classes ranging from seedlings to mature trees.

### Risk

Timber owners face a variety of risks that do not affect more conventional investments. Furthermore, timber resources are generally exposed to risks for a much longer time period than are more conventional investments. A wildfire, for example, poses a threat to young plantations and to naturally grown conifer stands until they reach sufficient size for crown closure. Thereafter, the risk diminishes greatly with age except where drought conditions and/or heavy buildups of fuel threaten a catastrophically hot fire. Hardwoods are generally at less risk from fire than conifers due to different fuel and site conditions.

Adverse weather poses additional risks for forestry investments. Drought can kill seedlings established by artificial methods such as seeding or planting. Timber mortality occurs in heavily stocked stands of all ages that are subjected to drought stress. Modification of certain cultural practices may be required for growing timber in ice, snow, and sleet belts. These conditions may also restrict the range of plantation-grown species. A moderate amount of destruction is caused annually by windstorms and tornados.

Both disease and insect pests are generally bad, and can cause problems for trees of all ages. Disease ranks as an insidious risk for forestry investments because of the difficulty of detection. If ignored substantial problems can develop. Examples include fusiform rust, blister rust and various forms of root disease. For timber investors the emphasis should be on prevention and detection. Certain insects pose a hazard in all life stages of trees. Southern and western pine beetles, and the spruce budworm are insects that typically respond to growth stress in maturing stands, especially those stands with high stocking density. Some insects attack regeneration while others attack stands in intermediate stages of development. For example, the gypsy moth attacks timber in any stage of development, and the risk of attack is not considered to be a function of time. As with diseases, the key to minimizing insect outbreaks is prevention and detection.

Although timber is subject to the same market risks as other investments, the risks are exacerbated by the long investment horizon. The relative values of various species change over time in unexpected ways. Costs and prices are affected by expected future supply and demand, whims in consumer preferences, technological change, and public policy. Regional impacts that must be considered include the availability of local timber markets and environmental constraints.

## Investment Expenditures

The way that investment expenditures are handled in an analysis depends on whether they are classified as capital expenditures, or as operating costs. A more detailed explanation of the tax treatment of both capital expenditures and operating costs is found in Chapter V.

**Land**—The costs of forest land and permanent improvements on the land are capital expenditures. They must be considered when forestry investments are compared with alternative uses of investment funds (e.g., forestry vs. common stock). In the example shown in Figure 1, the purchase price for cutover land is reported at the beginning of the investment period at \$300 per acre (year 0). Note that the terminal value of the land and permanent improvements is also shown as a revenue at the end of the investment period (year 34).

In analyses of land use alternatives, it is appropriate to exclude the cost of land if it is owned and common to both alternatives under consideration. Examples include comparisons of forestry vs. agricultural uses, intensive forestry (planting) vs. extensive forestry (natural regeneration), and forests managed exclusively for timber vs. management exclusively for wildlife.

The investment evaluation should consider the total acreage, not just the net productive acreage, in order to accurately assess the expected returns. Typical tree farms may have as much as 25 percent or more of their surface area in roads, rights-of-way, water, and other nonproductive acres.

Important considerations when purchasing forest land include productivity (site index), operability (slope, soil condition, etc.), accessibility (the nearness of roads), location, and current timber stocking.

**Merchantable timber**—Timber acquisition and establishment costs are also capital expenditures. An adequate number of trees of desirable species (growing stock) must be present to realize the productive potential of the investment. If trees exist at the time of acquisition, as either merchantable timber or as young growth or both, a portion of the acquisition basis must be proportionally assigned to each according to their relative fair market values (see Chapter V, page 18). The capital costs of establishing a timber stand, either following a harvest or in the conversion of open land, include the costs of site preparation, planting or seeding, and release of the seedlings from competing vegetation as necessary for seedling survival.

Future timber products and volumes should be projected when analyzing the investment. Data for making projections for most major species are available from timber yield tables published by land-grant universities and State forestry organizations. Yield tables are also published regionally by the USDA Forest Service and the Tennessee Valley Authority in the South. In addition, microcomputer software is available from major land-grant universities for most of the commercially important timber species. These programs make it possible for you to simulate a wide range of expected outcomes based on proposed or alternative operational management decisions.

**Annual operating and management expenses**—“Ordinary and necessary” forestry management expenses are operating costs rather than capital expenditures. Their income tax treatment will depend on the classification of the owner’s activity under the passive loss rules as discussed in greater detail in Chapter V. Generally, the impact of the passive loss rules on investment returns depends on when operating cost deductions are allowed to be taken. In Figure II-1, annually recurring property taxes and management costs are shown as being currently deductible for this particular investment example. Similarly, the timber stand maintenance cost in year 10 and the chemical release cost in year 3 are single expenses that are assumed to be currently deductible.

## Investment Revenues

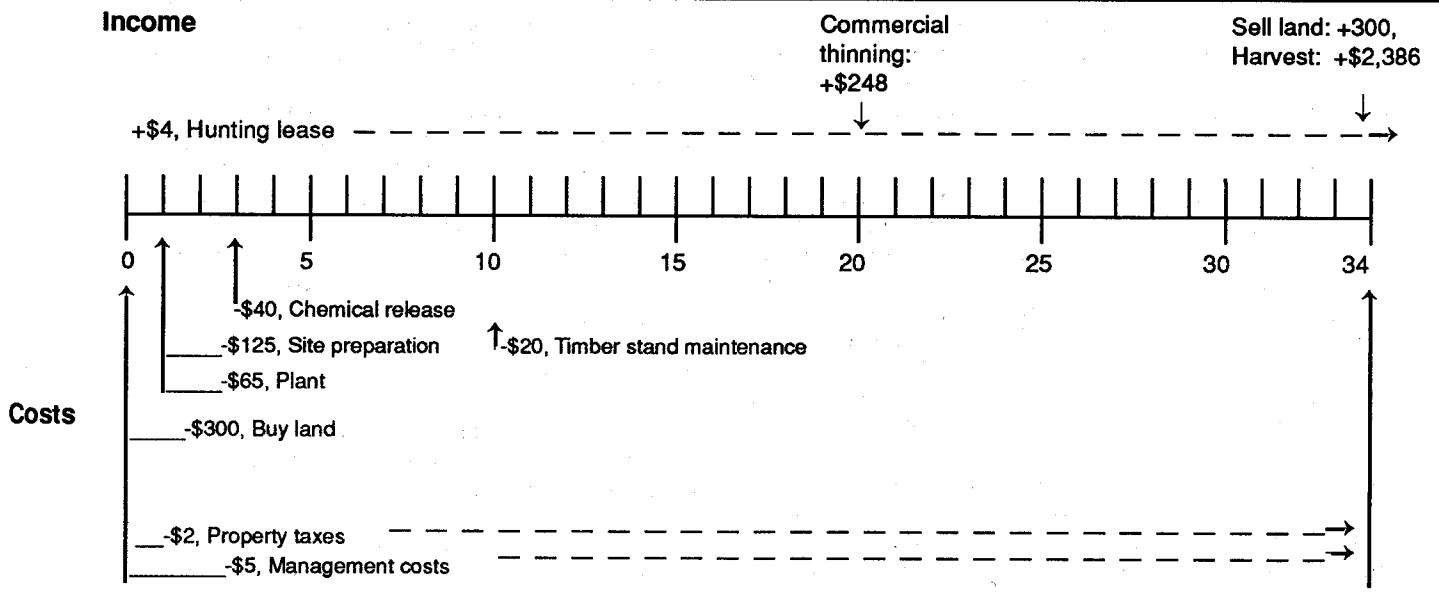
All revenues that accrue to the land as a result of the landowner’s investment and management activities should be included in the accounting.

**Timber sale**—Timber sales are normally the primary revenue sources for a forestry investment. Even-aged timber management cycles often include one or more intermediate harvests and a final regeneration harvest. For example, the intermediate thinning at age 20 (Figure II-1) produces revenue of \$248 per acre (10.8 cords x \$23 per cord). For an investment analysis, future revenues are based on volume projections coupled with price information that may be obtained from a variety of sources. In the South, prices are reported quarterly in *Timber Mart-South* as well as by several State services such as the Louisiana Forest Products “Quarterly Market Report.” In the Midwest, the Wisconsin “Forest Product Price Review” gives price information for Wisconsin. Price information is also available in other regions from the State Forester’s office or the State Cooperative Extension Service. Note, however, that care must be exercised in applying reported prices to your particular timber investment. The influences of topography, timber quality, competition among prospective markets, and several other factors all have a bearing on price.

**Hunting leases**—Hunting leases are one of the most important nontraditional sources of revenue from the forest. Annual revenues may range from \$1.00 to \$10.00 or more per acre—depending on location, size of the tract, and quality of the hunting. Additional capital outlays and management expenditures may be necessary to obtain the highest lease rates. When multiple uses such as hunting leases are added to the forest investment, the benefits should be carefully weighed against the added cost outlays and any foregone timber income. Hunting lease revenue is illustrated in Figure 1 with hunting income shown from years 0 through 34 at \$4.00 per acre per year. This amount is based on the assumption that the timber stands involved provide the diversity of age classes necessary for quality wildlife habitat and hunting. This lease income is treated as ordinary income for Federal income tax purposes.

**Miscellaneous revenues**—Other income from the forest may include recreational fees for camping, livestock grazing fees, and mineral revenues. Intensive recreational uses often involve modifications of forestry practices and correspondingly

Figure II-1—Timeline for a Timber Investment, Shown on a Per-Acre Basis in 1994 Dollars



increased costs. Similarly, mineral revenues may be substantial; however, such activities can involve sharply increased costs and/or impair timber site productivity. These high-risk opportunities should be analyzed separately from normal forestry investments on a case by case basis. In certain areas tipping (cutting boughs for garlands and wreathes), pine straw, nuts, and maple syrup generate additional income. Most miscellaneous revenue is treated as ordinary income for Federal income tax purposes.

### Economic Considerations

It is assumed here that your objective as a forest landowner is to analyze the financial return from a timber investment. There is no intent to evaluate personal nonfinancial objectives.

An individual's marginal income tax rate affects after-tax cash flows. The marginal tax rate (i.e., the rate applicable to the last dollar earned) is the appropriate one to use in the investment analysis. The noncorporate marginal tax rate for long-term capital gains revenue is capped at 28 percent.

When Federal or State cost-share payments are available for forestry practices, tax treatment alternatives should be considered. See Chapter VI for a detailed discussion of these provisions. The net effect of the cost-share payment on after-tax income should be incorporated in the analysis. The benefits of the reforestation amortization deductions and credit (discussed in Chapter V) should also be incorporated into the cash flows under consideration where appropriate.

### General Economic Trends

Inflation, through changes in the price level, affects all future cash flows. For example, land, timber, and equipment acquisition costs; and reforestation establishment costs are capitalized into the basis of the respective accounts in today's

(1994) dollars. The basis is the capitalized value (book value is another name) of the assets as purchased, inherited, or received by gift. Recovery of basis in timber for income tax purposes generally is done by a process termed cost depletion. The basis (in today's dollars) is subtracted from timber revenue in future (inflated) dollars at the time of timber disposal. The result is a diminished tax benefit from capital recovery over time. Therefore, after-tax analyses should be made in current terms (i.e., with inflation included) to avoid an inflation-induced overstatement of capital recovery benefits. Since all cash flows will reflect inflationary projections, it is imperative that the discount (interest) rate used for the analysis include a similar expectation factor for inflation. In summary, both elements of the analysis—i.e., cash flow and discount rate—must be kept in comparable terms (with or without inflation; and before- or after-tax) for reliable results.

Most forestry costs change at the rate of inflation in the economy; however, stumpage prices may increase (or decrease) at rates exceeding (or less than) inflation when supply/demand relationships change. These differential price trends can cause miscalculations in an investment analysis. Real (exceeding inflation) price appreciation—or price depreciation as the case may be—for some products such as southern pine and Douglas-fir sawtimber stumpage has received much attention, but other product prices such as those for pine and hardwood pulpwood, and equipment costs, have also been affected. Predicting the future is always uncertain and hazardous, so the best information available for projecting real changes in cash flows should be used.

### Economic Decision Criteria

The analysis of long-term forestry investments requires taking the time value of money into account. Discounted cash-flow techniques using compound interest satisfy that requirement. One of the most important considerations affecting investment results is the choice of a discount or interest rate (these

terms are sometimes used interchangeably). The investor is comparing the returns from timber with the expected returns from the best alternative opportunities available. These are referred to as the investor's alternative rates of return. The investor's marginal tax rate is used to adjust alternative rates of return to an after-tax basis for analyzing after-tax cash flows.

Four decision criteria are commonly used by investors to determine if independent investment projects should be undertaken. The following paragraphs present only a brief overview of these four criteria. A comprehensive treatment of the subject is found in *Essentials of Forestry Investment Analysis* by Gunter and Haney, discussed in Chapter XIII.

**Net present value (NPV)**—All costs and revenues are discounted to the present at the investor's alternative rate of return. If the net result is positive, an investment should be undertaken. Among mutually exclusive alternatives (those in which the selection of one precludes selection of others) of similar risk, the investment with the highest NPV should be selected. At the investor's alternative rate of return, the NPV is the contribution to his (her) net wealth from undertaking the project.

**The benefit/cost ratio (B/C)**—All costs and revenues are discounted to the present at the investor's alternative rate of return and the ratio of discounted revenues divided by discounted costs is calculated. Projects with B/C ratios greater than 1:1 are profitable; projects are selected on the basis of the highest B/C ratio. The B/C ratio is an expression of the return per dollar invested in a project for an investor's given alternative rate of return.

**Internal rate of return (IRR)**—IRR is the average compound interest rate that will be earned over the investment period. It is found by calculating the discount rate that makes the sum of discounted revenues and discounted costs equal to zero (i.e., the NPV will be zero). If the IRR exceeds the alternative rate of return, sometimes called the hurdle rate, the project should be undertaken. Mutually exclusive projects should be selected on the basis of the highest IRR, other things being equal. IRR is an expression of the rate of return for capital invested in a project.

**Equal annual equivalent (EAE)**—The EAE spreads the benefits and costs of an investment over its useful life in the same way that installment payments spread the cost of a loan over the payback period. Projects with unequal lengths can be compared using EAE's because infinity is the assumed investment horizon. This permits comparisons among projects of differing lengths, for example multiyear projects such as sawtimber versus pulpwood rotations, or multiyear projects versus annual crops. Independent projects with positive EAE's should be undertaken. For mutually exclusive projects, the one with the highest EAE should be selected, other things being equal.

Generally, the four criteria will rank investment projects similarly. However, they may rank projects differently under

conditions where: (1) projects have different lives, (2) the scale of one project is larger than that of others, and (3) cash flows of one project increase over time while the others decline. In such instances you should select the criteria that best meet your needs, or possibly use other factors in weighing the project's benefits.

A number of microcomputer programs are available to woodland owners for analyzing forestry investments. Examples include the Quicksilver Forestry Investment Analysis Program and TWIGS, both available from the USDA Forest Service, and the Tennessee Valley Authority's Yield Plus Program. These programs generally compute the decision criteria noted above as well as others. Some packages also include growth and yield simulators for a variety of species. Again, good judgement should be exercised in fully understanding the assumptions inherent in the results of any model's output.

### Timeline

A timeline is a diagram that helps you to visualize both the nature and the distribution of cash flows from the forestry project over the investment period (see Figure II-1). Cost cash flows are shown with a minus below the time-line. Revenue cash flows are shown with a plus above the time-line. The cash flows may be single amounts that occur only once in the investment period. An example is the timber stand maintenance cost in year 10 of \$20 per acre. Cash flows may also be periodic amounts that occur annually or at longer intervals. The property tax of \$2.00 per acre is an example of an annual cost that recurs throughout the investment period. A review of the time-line should ensure that all cash flows that have a bearing on the analysis are properly recorded.

### A Forest Investment Example

The procedure for evaluating an investment opportunity will be illustrated with an example intended to be typical of a management alternative that could be practiced in the Southeastern United States. Assume that a property for sale consists of marginal agricultural land that has been idle for several years. It would be similar to land retired under the Conservation Reserve Program (CRP). The forestry potential of this acreage is shown with all costs and returns on a per acre basis.

The initial investment in 1994 dollars per acre includes a beginning investment in land at \$300 (year 0) plus site preparation at \$125 and planting at \$65, both completed in the first year. These are all capital expenditures that must be recorded in the taxpayer's books as basis for later recovery as explained in Chapters VI and X. An herbicide application at \$40 to control competing vegetation and thus improve plantation growth, is incorporated in year three. In addition, annual property taxes of \$2 and annual management costs of \$5 are included. A further treatment at year 10 costing \$20 is applied for timber stand maintenance. These are assumed to be currently deductible expenses for income tax purpose as discussed in Chapter V.

The revenue for this example in 1994 dollars includes hunting lease income of \$4 per acre (ordinary income) in years 1 through 34, and a land sale of \$300 in year 34. Timber revenue includes thinning income of \$248 at age 20 and harvest income of \$2,386 at age 34 (see Table II-1). All cash flows are adjusted for a 3-percent general inflation rate. In addition, timber revenues are adjusted for a one-percent real price increase (see Table II-1). Prices are assumed to be \$23 per cord for standing pulpwood (5-9 inches dbh), \$56 per cord for chip-n-saw (10-12 inches dbh), and \$83 per cord equivalent for sawtimber (13 inches and above dbh) based on the Timber Mart-South regional average for the first quarter 1994. Expected price appreciation is based on USDA Forest Service projections of future price changes adjusted downward by 1 percent. Timber and land revenues are assumed to qualify for long-term capital gains treatment.

Timber yields are based on a loblolly pine growth and yield model for planted sites. The commercial thinning is expected to yield 10.8 cords per acre. The harvest clearcut at age 34 yields 6.8 cords of pulpwood, 29.0 cords of chip-n-saw, and 7.3 cord equivalents of sawtimber, per acre.

The landowner-taxpayer is assumed to be married, filing jointly, and in the 28 percent marginal tax bracket (i.e., 1994 taxable income is over \$38,000 but not over \$91,850); the long-term capital gains tax rate is also capped at 28 percent. A summary of cash flows is shown in Table II-2. The example is analyzed with the reforestation amortization and investment tax credit options incorporated as discussed in Chapter V. No cost-share payments are included in this example, although it would be a straightforward procedure to incorporate them in the analysis.

It is helpful to organize the cost and return information on a timeline as shown in Figure II-1 to be certain that the timing and amount of cash flows are properly accounted for in the analysis. The calculation of the decision criteria can be done with a hand calculator or the data can be entered in a microcomputer software program to analyze the investment as described above.

Forestry investments are very sensitive to the discount rate because of the long time period between planting and harvest. For after-tax analyses, the correct discount rate is the after-tax rate based on your alternative rate of return. If the next best alternative is a tax-free investment, such as a municipal bond, then the interest rate is used without adjustment as shown in Table II-3 for the 10 percent discount rate.

If the next best alternative is an investment, such as a corporate bond, that yields 10 percent annually with taxes subtracted before compounding, the correct discount rate is 7.2 percent, after-tax [10 percent  $\times$  (1 - .28 assumed tax rate)]. Alternatively, if the next best alternative is an investment such as an individual retirement account (IRA), certain saving bonds, or an alternative timber investment, where taxes are deferred until the end of the period rather than being subtracted before compounding, then the correct discount rate depends on the length of the investment period and when costs are incurred and revenues received. Assuming an initial investment, 10 percent interest, and a 28 percent tax subtracted at the end of 34 years, the approximate discount rate would be 8.942 percent.

The three discount rates discussed above are used to show the sensitivity of the analysis to the interest rate used. As the discount rate falls it is less expensive to carry the timber investment; therefore, the returns to timber projects improve with lower rates. The net present value, after-tax, in this example is \$256 at a 7.2 percent discount rate. It declines to -\$37 for the deferred, after-tax interest rate of 8.942 percent, and to -\$150 at a 10 percent discount rate (Table II-3). Only projects with positive net present values are acceptable. Therefore, you would not make this investment if your alternative rate exceeds 8.66 percent, after-tax, and you base the decision strictly on financial returns. The 8.66 percent rate is the IRR at which the NPV becomes zero as is discussed in the following paragraph.

The internal rate of return is the calculated rate that a timber investment earns. It is therefore independent of the discount

Table II-1—Transactions for a Forest Management Example in the South, Per Acre

No.	Activity	Year(s)	Current value	Rate of change*	Quantity
			\$/unit	%/year	
1.	Buy land	0	-300	0	1.00 acres
2.	Site preparation	1	-125	0	1.00 acres
3.	Planting	1	-65	0	1.00 acres
4.	Property tax	1-34	-2	0	1.00 acres
5.	Management fee	1-34	-5	0	1.00 acres
6.	Herbicide	3	-40	0	1.00 acres
7.	TSI	10	-20	0	1.00 acres
8.	Use fees	1-34	4	0	1.00 acres
9.	Commercial thinning	20	23	1	10.8 cords
10.	Final harvest (pulpwood)	34	23	1	6.8 cords
11.	Final harvest (chip-n-saw)	34	56	1	29.0 cords
12.	Final harvest (sawtimber)	34	83	1	7.3 cords
13.	Land sale	34	300	0	1.00 acres

\* All cash flows are adjusted for the general level of inflation (3 percent in this example) plus the differential rate of change shown here.

Table II-2—Cash Flows With Inflation and Taxes for the Investment Example, Per Acre

Year	Cost	Cost with inflation	Benefits	Benefits w/inflation	Tax effect	Net income with tax	Net income w/o tax
Dollars							
0	-300	-300	0	0	0	-300	-300
1	-197	-197	4	4	23 *	-170	-193
2	-7	-7	4	4	8	5	-47
3	-47	-51	4	4	20	-39	-3
4	-7	-8	4	5	8	5	-3
5	-7	-8	4	5	8	5	-3
6	-7	-8	4	5	8	5	-3
7	-7	-8	4	5	8	5	-3
8	-7	-9	4	5	5	1	-4
9	-7	-9	4	5	1	-3	-4
10	-27	-36	4	5	9	-22	-31
11	-7	-10	4	6	1	-3	-4
12	-7	-10	4	6	1	-3	-4
13	-7	-10	4	6	1	-3	-4
14	-7	-10	4	6	1	-3	-4
15	-7	-11	4	6	1	-3	-4
16	-7	-11	4	6	1	-3	-4
17	-7	-11	4	7	1	-3	-5
18	-7	-12	4	7	1	-3	-5
19	-7	-12	4	7	1	-3	-5
20	-7	-12	307	555	-152	391	542
21	-7	-13	4	7	2	-4	-5
22	-7	-13	4	8	2	-4	-5
23	-7	-13	4	8	2	-4	-6
24	-7	-14	4	8	2	-4	-6
25	-7	-14	4	8	2	-4	-6
26	-7	-15	4	9	2	-4	-6
27	-7	-15	4	9	2	-4	-6
28	-7	-16	4	9	2	-4	-6
29	-7	-16	4	9	2	-4	-7
30	-7	-16	4	10	2	-5	-7
31	-7	-17	4	10	2	-5	-7
32	-7	-18	4	10	2	-5	-7
33	-7	-18	4	11	2	-5	-7
34	-7	-19	3,651 **	9,974	-2,703	7,252	9,955

\* This value includes a 10% tax credit on the original cost, plus the annual expense deductions and the amortization deduction. It is based on 95% of the reforestation cost times the 28% marginal tax rate with 1/14 deducted in years 1 and 8 and 1/7 in years 2 through 7.

\*\* All costs and revenues, including land, are increased by 3 percent annual inflation. Timber revenues are increased by an additional 1 percent real price increase.

rate. In the example, the IRR for the investment is 9.31 percent, before-tax, and 8.66 percent, after-tax. For independent projects, an acceptable IRR should exceed the investor's alternative rate of return. For mutually exclusive projects, the alternative with the highest IRR after-tax, other things being equal, would be accepted. Thus, the investment example will be an acceptable project if the landowner-taxpayer has an alternative rate that does not exceed the 8.66 percent IRR after-tax.

At a 7.2 percent discount rate, the benefit/cost ratio is 1.47:1; that is, the investment returns \$1.47 for every \$1.00 invested in present value terms, after-tax. The benefit/cost ratio also declines as rates increase. At the deferred rate of 8.942 percent the present value of benefits is only \$0.93 per dollar invested,

and at the 10 percent tax-free discount rate the present value of benefits is \$0.93 per present value dollar invested. Only projects with a benefit/ratio greater than 1:1 are acceptable, so the timber investment would be accepted only if your decision was based on rates below 8.66 percent, after-tax.

The equal annual equivalent shows how much the investment would return each year. This value is useful for comparing timber returns with annual returns from farm crops. At a 7.2 percent discount rate, the EAE is equivalent to receiving a net after-tax return of \$20 per year over the investment period, but only -\$3.51 at the 8.942 percent deferred discount rate and -\$16 at the 10 percent rate. Only investments that yield positive EAE's are acceptable.

Table II-3—Analysis of the Forestry Investment Example, Per Acre

Criteria	Discount rate, after-tax	Criteria value after 28% tax
Tax treatment of best alternative	Percent	
Net present value		
10% return with annual tax	7.200	\$255.77
10% return tax deferred 34 years	8.942	(-37.13)
10% tax free	10.000	(-150.47)
Benefit/cost ratio		
10% return with annual tax	7.200	1.47:1
10% return tax deferred 34 years	8.942	0.93:1
10% tax free	10.000	0.71:1
Equal annual equivalent		
10% return with annual tax	7.200	20.46
10% return tax deferred 34 years	8.942	(-3.51)
10% tax free	10.000	(-15.66)
Internal rate of return (before-tax 9.31%)		8.66%

### Summary

A forestry investment must be analyzed within the context of your personal goals. Because these investments are long-term, an objective decision framework that takes into account the time value of money is required. The investment criteria give appropriate decision rules for comparing alternatives, but the results are only as useful as the accuracy of the estimates of costs, revenues, and discount rates used. Therefore, expected values of each economic variable should be chosen carefully.

Forestry investment decisions are always made on the basis of limited and incomplete information because no one can see into the future. The examples given to illustrate the method of analysis are valid only for the specific assumptions and information used here. The method, however, is generally applicable to a wide variety of investment situations. This framework should allow you to compare forestry investments with other investment alternatives on an objective basis if all information affecting the outcomes is considered. Good judgment fostered by experience is essential for tempering the choice of inputs and for evaluating the results while including intangibles and personal considerations.

## Chapter III. Tax Planning

### The Planning Team

Achieving the maximum potential from your timber property requires the development and implementation of an integrated forest management, estate, and financial plan. Depending on the complexity of your circumstances, and your willingness to become personally involved in the timber, legal, financial, and tax aspects, you may need the technical expertise of a consulting forester, accountant, lawyer, or other investment advisors. The role of each of these individuals is discussed in the context of the planning considerations that should be made.

### Developing an Integrated Plan

#### Introduction

The financial objective for your timber activity should be to maximize the after-tax return on the funds you have committed for the benefit of whomever you desire. If your objective is to merely enjoy the woodland, your activity most likely constitutes a hobby and should be treated accordingly for tax purposes. Personal enjoyment and profitability are not incompatible goals, but any expenditures you make that do not contribute directly and materially to profitability may not receive favorable tax treatment. Thus, your forester should draft the forest management plan so that the prescriptions recommended and their impact on profitability are clearly stated and understood. Similarly, the accountant should advise on the recording of expenses in your accounts so you can distinguish between profit oriented and pleasure oriented outlays.

Tax planning does not mean tax evasion. Rather, it means arranging your affairs so that you pay only the tax required by law, which takes into account the advantage of any conservation incentives included in the law. Your accountant may suggest tax deferral, shifting of tax burdens among family members, and timing of cash flows using the cash method of accounting as legal planning strategies to minimize your taxes. Your accountant and attorney should be familiar with the forest management plan so that they can anticipate opportunities to assist you in making favorable tax adjustments in the timing of revenues and expenses.

A consistent tax strategy is important. You should evaluate your goals and the extent of your forest resources and decide if your operations constitute an investment, or if they rise to the level of a business (see Chapters IV and XI). Your accountant and attorney can assist you in making a determination that best fits your circumstances. Then your records for reporting of income and deducting of expenses should be handled accordingly.

#### Advantages of Timber Investments

Timber investments as a rule are not tax shelters since, among other things, you cannot deduct more than your out-of-pocket investment in the activity. In fact, many

expenditures must be carried in a timber account for years before being recovered. Likewise, long-term borrowing on timberland is limited to institutions such as the Farm Credit Bank (formerly Federal Land Bank) and a few insurance companies that specialize in timber loans. Some commercial banks make short-term loans on timber property.

For a given level of risk, however, timber may increase the return to your overall investment portfolio. Since no tax is due until gain is recognized, the law favors investments that yield appreciation rather than annual income. Timber provides a means of tax deferral—that is, the value accumulation through growth and product change is not recognized until the timber is harvested. It appreciates in value due to growth in volume, in-growth into more valuable product categories (e.g., pulpwood into sawtimber, etc.), increase in quality, and long-run-real (in excess of inflation) price increases. Thus, woodlands with adequate growing stock appreciate in value over time and require very little management attention other than monitoring the timber stocking levels and protection from insects, disease, and trespass. Your forester should be routinely involved in this process.

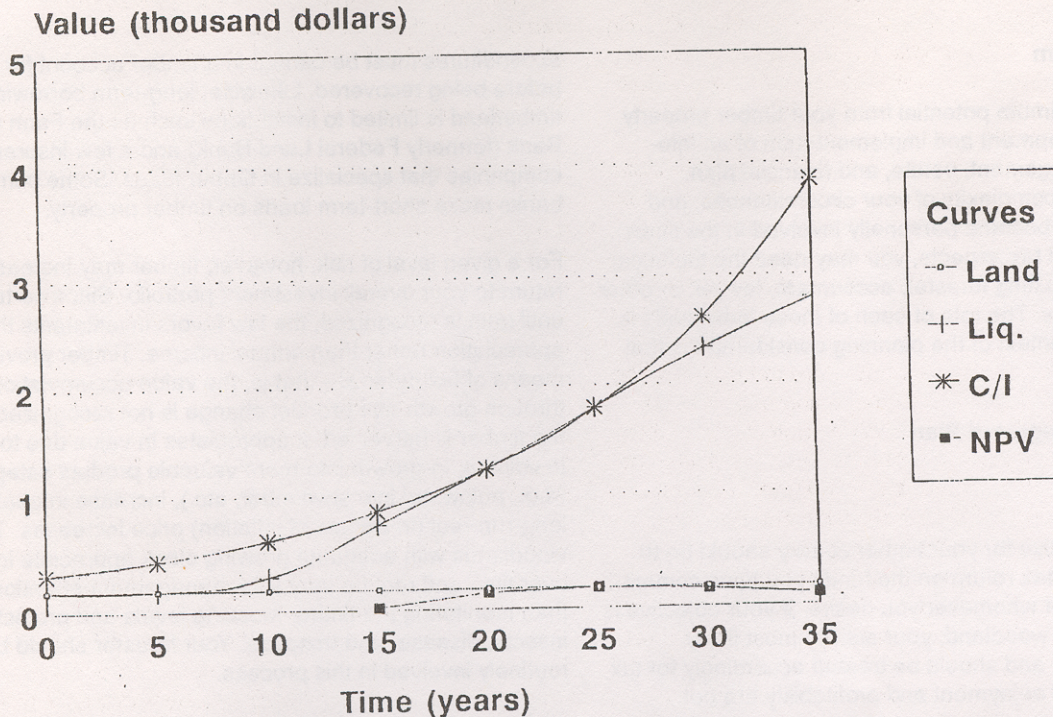
Timber property may serve as an inflation hedge because it provides considerable flexibility in harvest timing. This is illustrated in Figure III-1 with a stand that can be harvested within 3 to 4 years prior to or after an optimum rotation determination, with a minimum amount of foregone income potential (detailed discussion is found on page 12). Furthermore, income realization can be timed to meet cash needs or tax considerations because, within limits, cutting can be delayed or accelerated—thus affecting income and/or tax liability in a given tax year. The marginal tax rates for the year income is shifted from and to must be considered.

For highly appreciated timber property (low basis), the recognition of income can often be deferred for income tax purposes until retirement. Short-term cash needs can be accommodated by borrowing with the woodland as collateral more effectively than by a sale. Although timber is somewhat illiquid, it may provide a financial reserve to meet cash needs. Both your forester, who can determine the optimum timing of timber cutting for given assumptions about cost and revenues, and your tax accountant, who can advise as to the tax impacts of various management alternatives, should be involved in this process.

#### Estate Planning Role

Timber can be used as the component of a portfolio designed to accumulate wealth for transfer to heirs. You may want to arrange your affairs to minimize liability for estate and other transfer taxes. Thus, timberland is often a good candidate for a short-term trust or intergenerational joint ownership. Forest property is also a good candidate for a family gifting program to reduce the gross estate value to less than the Federal estate tax threshold. There are also other advantages for using timber as a gift. These include situations where it is

Figure III-1. Timing of investment, annual management expense, and harvest revenue.



**Loblolly Pine on an Average Site -- NPV @ 6% -- IRR @ 8.24%**

desired to spread income tax liability among family members. Gifts, however, have one key disadvantage in addition to loss of control. Gifted property retains the donor's basis, which often is quite low, as opposed to stepped up basis for property passed at death. If a gift tax has been paid, the donee's basis may sometimes be increased by part of the amount paid. Your attorney and accountant should be consulted on the tax consequences of specific actions and on the overall impact on your estate planning.

The tax liability of a family can in many cases be minimized by shifting income from higher to lower bracket family members through gifts of income producing property. The Uniform Gifts to Minors Act facilitates income shifting. Under the Act, a gift of intangibles can be made to a minor, but with an adult serving as custodian. Usually, a parent who makes the gift is also the custodian. State law allows the custodian to manage the assets provided there is no commingling of the child's income with the parent's property. Such planning is limited by the tax liability calculation for a child under the age of 14. Your accountant can help evaluate the tax implications of various gift alternatives.

Timberland estates may qualify for special use valuation (Section 2032A of the Internal Revenue Code) and for deferral and extension of estate tax payments (Section 6166). Timber, as a renewable resource, can often provide funds to meet transfer tax liabilities without having to liquidate nonrenewable family business assets. Your forester can assist in the valuation of woodland assets for special use

valuation and the attorney or tax accountant, or both, can assist in making the appropriate elections.

**Planning Implications**

Various timber characteristics lend themselves to specific planning implications. Deferral of income is an example. The trees generally increase in volume (quantity) and value annually, but the increase in value is not recognized until the trees are harvested.

*Substantial Initial Investment*—The acquisition of woodland generally requires a substantial initial investment with little possibility of immediate cost recovery, unless merchantable timber is acquired. For example, purchase of timberland includes a bare land value at an average cost of \$300 per acre. If not stocked, reforestation costs can vary from \$100 to \$300 per acre depending on site index (productivity), operability, and other factors. To minimize the time over which such costs must be carried, you should ensure that the proper portion of the available basis is allocated to each asset account (Chapter V), amortize qualified reforestation expenditures (Chapter V), and claim the reforestation investment credit (Chapter V). The costs allocated to timber basis that cannot be amortized will usually be recovered only as the timber matures and is sold (see Figure III-1).

Figure III-1 illustrates several points. First, the liquidation curve shows the merchantable volume that could be harvested over time from an acre planted to loblolly pine of

average productivity in the south. This particular curve assumes that the timber brings a constant price per cord and is managed on a no-thin regime. Timber production is also assumed to be the highest and best use for this land. Even in this simple example, timber production is a capital intensive undertaking that involves land, establishment costs to obtain adequate growing stock, and annual operating costs that must be committed for long periods of time. Second, net present value (NPV) calculations at a 6 percent cost of capital are shown for 5-year intervals indicating for these inputs that age 25 is an optimum rotation age. But notice that on either side of this optimum rotation the NPV deviates only moderately. Finally, if the establishment costs and the annual costs are compounded forward and plotted they form a cost curve [see the cost/income (C/I) curve on Figure III-1]. Similarly, if potential revenues are discounted backward to the beginning of the investment, subtracting the intervening annual costs and plotting them, the figure shows an income curve. In this special case where the income and cost curve are plotted at 8.24 percent, the internal rate of return (IRR) for these inputs, the curves coincide. With IRR as a decision criterion the curves show that the ideal harvest timing would be at approximately 23 years of age—the point of tangency between the cost/income and liquidation curves. The vertical distance between the income/cost and the liquidation curves, gives a measure of foregone income between potential and actual. It is small in the vicinity of an optimum harvest age. The figure illustrates graphically that you have a decision window in which you can make a harvest decision that meets your personal goals with only a small sacrifice of potential income.

Good forest valuation and accounting information is necessary for effective planning. The forester can generate the valuation information, and the accountant can see that the proper allocation is made to the original basis in the appropriate capital accounts.

*Long Preproductive Period*—Consider structuring your timber activity to allow the deduction of qualified expenses against other (non-timber) income where appropriate. This usually involves organizing the woodland as a business with material participation on your part (Chapter V). Early payment of expenses at the end of the tax year accelerates the benefit of the deduction. Otherwise, try to acquire timberland with a good distribution of timber age classes.

You also should develop an awareness of marginal tax rates on cash flows. Tax shifting from one year to the next has been limited by Congress; however, management decisions can often be made to alter the income/cost timing to take advantage of lower marginal tax rates.

#### **Tax Considerations When Timberland Is Acquired**

It may be helpful for you to develop and maintain in your files a management plan documenting your intention to manage the property for profit, and to include an estimate of projected profit. Your forester should be able to make this projection routinely as part of the management or estate plan. Establish accounts to which the costs of acquisition, or values associated with acquisition if the property is inherited, are allocated according to the relative fair market value of each component of the property acquired. Do so while the information is readily at hand (see Chapters V and XIV). You should file for property tax relief if special forest property tax laws exist in your State.

Both your forester and tax accountant should be involved in identifying and incorporating these opportunities in ways that are most advantageous with regard to your long-term goals. Your forester and accountant should coordinate the timing of the revenues as well as the treatment of all costs as discussed above. Finally, planning is a dynamic activity that must keep abreast of your family situation, the economy, and tax law changes. Your advisors should be included in all phases of the process in order to help you fully realize your goals for your woodland property.

#### **Tax Considerations When Selling Timber**

Maximize after-tax income by taking all allowable deductions against timber sale proceeds. Report net timber income as a long-term capital gain if it qualifies (Chapter VI). Capital gains do not affect the amount of social security retirement received and the self-employment social security tax is not due on the net sale income (see Chapter IX). Consider deferring receipt of a portion of the sale proceeds only if the resulting tax saving exceeds the opportunity cost of not having use of the deferred funds (see Chapters II and IX).

## Chapter IV. General Tax Considerations

### Types of Forest Ownership and Operation

How you may treat the expense and income items associated with your woodland depends on your purpose for owning the property, your use of it, your taxpayer classification with respect to the property, and the nature of the expense/income item itself. For example, property tax payments on nonbusiness property (personal or investment) are deductible by individual taxpayers because they are among the allowable itemized deductions for individuals. Property tax expenditures on business property are deductible business costs. The expenses of protecting woodland from fire, however, can be deducted only if you hold the property for the production of taxable income either as an investment or as a business. If an individual does not materially participate in the business, however, the passive loss rules, which are discussed on page 28, will apply.

Hunting lease income or other fees received for using your land are ordinary income under all types of ownership. Income from the disposition of timber, however, may qualify for long-term capital gain treatment. Capital gain status depends on how long you have owned the timber; how it is disposed of; and whether or not you hold it as an investment, or as part of a business. See Chapter VI for a detailed discussion of how to meet the qualifications for capital gains treatment.

### Purpose for Holding Timber

Timber property can essentially be held for one of three basic purposes, or some combination of them:

*Personal use*—Property not used to produce income is classed as being held for personal use. The house and land that serve as your residence is an example. Even though you might expect to sell it some day for more than you paid, the primary reason for having a residence is to give you a place to live. Likewise, you may own forest property primarily for personal enjoyment—such as for hunting, fishing, or other recreational pursuits; or as a second home site.

*Investment*—Woodland used to produce income may in many cases be investment property rather than a business. If timber production is not your principal or a major source of income, but you otherwise manage the property for the eventual realization of a profit, you may be holding it as an investment. Absentee owners often qualify as investors because their timber related activities are motivated primarily by profitability rather than for other purposes.

*Business*—Property is considered as held for use in a business if it is part of an activity entered into and carried out for profit on a more regular basis than in the case of an investment. In addition, you may be holding your timber "primarily for sale" to customers in the ordinary course of a trade or business. Two characteristic elements of a business

are regularity of activities and transactions, and the production of income (See Publication 334, "Tax Guide for Small Business," Chapter 1). Your relationship with any business in which you own an interest is considered to be either "active" or "passive" in nature.

*Active business interest*—You are actively engaged in a business if you "materially participate" in conducting it. To materially participate, you must personally participate on a regular, continuous, and substantial basis in the conduct of the activity.

*Passive interest*—Your relationship with your trade or business is passive if you do not materially participate in its operations. These distinctions are discussed in more detail in Chapter V.

The determination of your primary reason for holding a particular woodland property is based on all the facts and circumstances related to your intended and actual use of the property. No single factor is controlling, but your activities at the time of determination are very important. Because of the unique nature of most forest property, there are usually elements of personal use associated with its status as either an investment or a business. You should be careful to distinguish those activities associated with profit from those associated with personal pleasure in your recordkeeping and tax reporting. That is, you should have a clear business or investment purpose for each deduction taken. Adequate records should be kept as proof.

### Types of Taxpayers

The two basic types of taxpayers are individual and corporate. An individual engaged in a business as a sole proprietor reports all income except capital gains and all expenses on either Schedule C or Schedule F of Form 1040. The net income (or loss) from these forms is transferred to the first page of Form 1040 for inclusion in the taxpayer's gross income. Investment income from timber is virtually always capital gain.

Although partnerships file tax returns, they are information returns only. Partnerships do not pay taxes themselves. Information returns report the income and other tax items associated with the activity for the year and how these items are to be distributed (passed through) to the individual partners. Income from all sources is consolidated on the individual tax return, and the appropriate individual tax rate is then applied to total taxable income. Note that joint ownership of property does not necessarily create a partnership for tax purposes. A partnership for tax purposes exists if there is the joining together of two or more persons or other legal entities to carry on a trade or business, with each contributing to the venture, and each expecting to share in the profits and losses of the activity. A woodland ownership may be a partnership if its operations are treated as a partnership under the law of the State where the property is located.

Certain corporations may elect to be taxed like a partnership. Corporations making this election are referred to as S corporations. Those not making the election are referred to as C corporations.

Individual taxpayers report their portion of partnership or S corporation income (or loss) on Form 1040, Schedule E. Net income (or loss) from Schedule E is then transferred to the first page of Form 1040 for inclusion in the taxpayer's gross income.

A new organizational structure called a limited liability company (LLC) is now possible in most States. It provides the limited liability of a corporation, and the pass through tax treatment of a partnership.

Estates and trusts represent a special case. They may or may not pay income tax as separate taxable entities, depending on the particular circumstances involved. However, if income is retained by either an estate, or a trust, a fiduciary return must be filed by the executor of the estate or by the trustee of the trust. The current rate structure, with very low thresholds for the higher income tax brackets, discourages retaining income under ordinary circumstances. See IRS Publications 448, "Federal Estate and Gift Taxes," and 559, "Tax Information for Survivors, Executors, and Administrators."

Forms of timberland ownership and business organization are discussed in greater detail in Chapter XI.

## Structuring Your Timber Activities

It is important for you to consider your ownership and financial goals, the extent of your woodland resources, and perhaps other factors before deciding which structure is best for your woodland and on an income tax strategy. Once you have made this decision, it should guide a consistent approach to recordkeeping, tax reporting, and management decisions until your circumstances change.

How your timber-related activities are classified is generally dictated by their scope and nature. If you own a small acreage and have only occasional transactions, you are most likely treating the activity for tax purposes as an investment. If your holdings generate fairly regular and continuous transactions, your activities may constitute a business. In this case, you should evaluate which structure your business should have to best achieve your objectives. In many cases you will treat it as a sole proprietorship. If your family is involved you may want to execute a partnership agreement, incorporate, or consider the new LLC form of organization.

There are tax advantages and disadvantages associated with both the investment and the business categories. Tax considerations, however—although important—are usually not the primary factor that determines the best structure. This decision should be made only after careful consultation with your legal, financial, and forestry advisors.

## Chapter V. Cost Considerations

### Capital Costs

For Federal income tax purposes, your expenditures as a forest owner may generally be classified as one of three types: (a) capital costs, which comprise basis; (These costs include those that are recoverable through allowances for depreciation and amortization, as well as those that are recoverable only when the asset is sold or otherwise disposed of) (b) currently deductible expenditures for management costs, taxes, and interest; and (c) costs of sale. The first two types are discussed in this chapter; costs of sale are discussed in Chapter VI.

Money spent to acquire real property or equipment, or to make improvements that increase the value of real property or equipment already owned, is classified as a capital cost. Examples of capital expenditures are those for purchase of land, timber, buildings, and for machinery and equipment having a useful life of more than 1 year. Other examples include funds expended for construction of bridges, roads, and firebreaks; for site preparation, tree planting, and seeding; and for major repairs that prolong the life of machinery and equipment. All costs associated with the purchase, planting, or seeding of timber are capital expenditures. Generally speaking, the property owner who incurs the capital costs is entitled to offset or deduct such costs against income arising from the property—and in some cases, against income from other sources.

Capital costs usually cannot be deducted from income in their entirety in the year they are incurred. Instead they must be used to establish or add to a capital account. This process of recording costs in an account so that they may be recovered over a period of years as the property is used up or worn out, or upon disposition of the property, is called "capitalization." At any given time the dollar value recorded in each account represents the amount of unrecovered capital costs currently invested in property for that account. The basic rules governing which timber-related costs must be capitalized are discussed in this chapter, as are recent changes in certain of the methods of capital cost recovery.

### Original and Adjusted Basis

When a capital asset is first acquired, the amount to be entered into the account for that particular asset depends on how the property was obtained, as discussed in the following paragraphs. This amount is the original basis of the acquired property. The original basis may change as capital improvements are made to the asset—or as allowances for depletion, amortization, or depreciation are deducted. Capital improvements will increase the basis; allowances for depletion, amortization, and depreciation will decrease it. Procedures for making these changes are discussed in detail in Chapter XIV. The balance remaining in an account at any point in time after one or more changes have been made to the original basis is called the adjusted basis.

*Purchased Assets*—If a capital asset is purchased or funds are expended for its establishment as with reforestation, the original basis is its acquisition or establishment cost. This is the first entry to be placed in the capital account for that particular item.

*Inherited Assets*—The original basis of an inherited asset is its fair market value (or special use value if so elected) on the date the decedent died or on the alternate valuation date provided by Federal estate tax law. The alternate valuation date, if elected, is the earlier of 6 months after the decedent's death or the date an estate asset is sold. The value of most assets is usually greater than the decedent's basis. Passing title by inheritance, therefore, generally results in a "stepped-up" basis for the property in the hands of the new owner. This can result in large income tax savings if it is sold. A Federal estate tax return may not be required for many estates. In that case, the appraised value at the date of death for State death tax purposes should be used as the original basis. Otherwise, use the fair market value of property at the date of death.

*Assets Received by Gift*—In most instances, the original basis of an asset received by gift is based on the donor's adjusted basis. This is the case when the fair market value of the gift on the date it is made is more than the donor's adjusted basis—which is the usual situation. For pre-1977 gifts of this type, the new original basis is the donor's adjusted basis plus the entire amount of gift tax paid, if any, not to exceed the fair market value of the gift when made. For such gifts made after 1976, that portion of the gift tax, if any, applicable is the difference between the donor's adjusted basis and the gift's fair market value on the date made which is added to the donor's adjusted basis. If the fair market value of a gift when made is less than the donor's basis, then the donee's original basis for loss purposes is the fair market value.

*Other Types of Acquisition*—Other, less common ways of acquiring property include non-taxable or partly taxable exchanges and replacement of involuntarily converted property (see page 46) such as that damaged or destroyed by casualty or lost by theft. For a detailed discussion of these types of situations, see IRS Publication 551, "Basis of Assets."

*Allocation of Original Basis*—Sales contracts and other instruments transferring forest property often do not list separate prices or values for the land, timber, and other assets when these are acquired in a single transaction. The total basis in such situations must then be allocated among the various assets according to the separate fair market value of each on the date the property was acquired. Example V-1 illustrates and explains the allocation procedure. This requirement applies no matter when the allocation is actually made—even if it is done many years after the acquisition. If the timber represented a significant part of the total value of the property when it was acquired, but its quantity and value

### Example V-1

**Establishing land and timber accounts:** You bought a 100-acre tract of timberland in 1991. The contract price was \$58,000, but you also paid \$800 to have the boundaries surveyed, \$350 for a title search and closing costs, and \$1,200 to have the timber cruised. Therefore, your total acquisition cost was \$60,350.

The timber cruise conducted at the time you made the purchase determined that the tract contained 1,000 cords of merchantable pine pulpwood on 90 acres. There were also 10 acres of young growth (trees of premerchantable size) that contributed to the value of the property. The fair market value of the merchantable timber on the date of purchase was \$26 per cord. The young growth had a fair market value of \$200 per acre. The fair market value of the land itself, not considering the timber, was \$275 per acre. Therefore, the sum of the separate fair market values of all of the assets purchased was \$55,500. In this case, as is very often the situation, the total of the separate fair market values of the various assets purchased does not equal the total acquisition cost.

Now, you can figure your original cost basis for the land, merchantable timber, and young growth by determining the proportion of the total fair market value represented by each and multiplying this ratio by the total acquisition cost. For example, dividing the fair market value of the merchantable timber by the total fair market value,  $\$26,000/\$55,500 = 0.4685$ , and multiplying by the total acquisition cost,  $0.4685 \times \$60,350$  gives an original cost basis of \$28,274 for the merchantable timber. The original cost basis for each of the assets, determined in the same way, is shown in the following tabulation, and is reported on Schedule B of Form T (Fig. V-1).

#### Determination of Cost Basis

Asset	Fair market value	Proportion of total fair market value	Original cost basis
Land	\$ 27,500	0.4955	\$ 29,903
Young growth	2,000	0.0360	2,173
Merchantable timber	<u>26,000</u>	<u>0.4685</u>	<u>28,274</u>
Total	\$ 55,500	1.0000	\$ 60,350

as of that date are unknown, you will probably need a forester's help to make these determinations. Only timber with a fair market value as of the date of acquisition should be included in the basis valuation. This means that if the allocation is being made after the acquisition date, the present timber volume must be reduced by the amount of growth that has occurred since the timber was acquired.

#### Establishment of Accounts

**Land Account**—Assets that are placed in the land account include the land itself and non-depreciable land improvements. Nondepreciable land improvements include earthwork assets of a permanent character, either acquired with the property or constructed later. Examples are the roadbeds of permanent roads (those with an indeterminable useful life to the landowner); land leveling; and earthen impoundments. Their basis, like that of the land itself, generally can only be recovered when you sell or otherwise dispose of the land.

**Depreciable Land Improvement Account**—Depreciable land improvements include bridges, culverts, graveling, fences, fire towers, and other nonpermanent structures and improvements. Temporary roads, such as those to be abandoned after completion of a logging operation, may also be depreciated (or amortized). The costs of temporary firebreak

construction are treated the same as the expenses of constructing temporary roads. Depreciation is discussed in greater detail later in this chapter.

**Timber Accounts**—The timber account should include, if applicable, separate subaccounts for merchantable timber, young growth (naturally seeded trees of premerchantable size), and plantations (planted or artificially seeded trees of premerchantable size). Additional accounts can also be established using other criteria such as species and location. Each of these subaccounts should include two entries—one showing the quantity of timber and the other its dollar basis. For merchantable timber, the quantity is shown in volume measurement terms such as cords or thousand board feet (MBF). For premerchantable timber, the quantity is shown as number of acres. At the time timberland is acquired, a reasonable amount of the basis should be allocated to young growth if it contributes to the overall value of the property.

The procedure outlined in Example V-1 should be used. It is important to remember that basis allocation must be made with reference to the relative fair market values of the various capital assets comprising the property at the time it is acquired. If only cutting rights are acquired, all costs related to the acquisition should be charged to the timber account.

The quantity of merchantable timber to be entered in the timber account as of the date of acquisition should be the volume that the tract would have produced if all of the merchantable timber had been cut and processed at that time in accordance with the prevailing utilization standards in the locality. As explained above, the quantity of merchantable timber should be expressed in terms of thousand board feet, cords, or some other standard unit of timber measure.

The plantation and young growth subaccounts reflect the establishment of timber stands by planting, or by natural or artificial seeding (see summary of Revenue Ruling 75-467, page 91). As mentioned above, all timber establishment costs are required to be capitalized. Establishment costs include funds spent to prepare a site for tree planting or seeding, for seedlings and tree seeds, and for labor and supervision. Site preparation costs, in turn, are those incurred for brush, weed, and stump removal; and for leveling and conditioning the land to afford good growing conditions and to facilitate planting or seeding. They also include the costs of killing or removing cull or low-value trees to facilitate the natural regeneration of desired species, and the baiting of rodents.

Other related costs that must be capitalized include the allocable depreciation charges attributable to equipment used in site preparation, planting, and seeding—such as trucks, tractors, and tree planters. The term "hired labor" includes family members without an ownership interest in the property who are actually paid for their services, but it does not include yourself. In certain cases, "hired labor" may also include your spouse. You, as a taxpayer, cannot capitalize the cost of your own labor. Some expenditures made after seeding or planting are also establishment costs, such as those for brush and weed control, because a stand is not considered established until a number of individual stems sufficient to adequately stock the site with the desired species are capable of surviving. (See summary of Revenue Ruling 76-290, page 92).

The costs of replanting or reseeding after seedling mortality, such as death by drought, also have to be capitalized. Depending on the cause of death, however, you may be able to claim the loss as an income tax deduction as explained later in Chapter VII.

Capitalized reforestation costs in a tax year to a maximum of \$10,000 may be recovered by being immediately amortized over a period of 84 months rather than by waiting to deduct them from sale proceeds when the timber is cut or otherwise disposed of. The amortization procedure is described later in this chapter. Deductions against sale proceeds are discussed in Chapter VI.

Volume and value entries from the young growth and plantation subaccounts should be transferred to the merchantable timber subaccount as soon as the trees in those two subaccounts become merchantable. The dollar amount and the number of units are added directly to the merchantable timber account as shown in Example V-2.

#### **Example V-2**

**Adjustment of timber accounts:** In 1994 you remeasure the timber you bought in example V-1. You determine that the young growth has reached merchantable size and contains 80 cords. Therefore, you transfer the dollar amount shown in the young growth subaccount and the estimated number of units to the merchantable timber subaccount. The closing 1994 (opening 1995) balance in the merchantable timber subaccount is, therefore, \$30,447 (\$28,274 plus \$2,173). The balance in the young growth subaccount is reduced to \$0. The remeasurement also indicated that the timber on the 90 acres grew by 200 cords. Report the transfer on Schedule F of Form T (Fig. V-2).

**Equipment Accounts**—Accounts also have to be established for depreciable equipment and machinery. This will usually consist of a subaccount for each item or class of items—such as power saws, tractors, trucks, and planting machines. The basis of such items should be adjusted (increased) by any amounts spent for major repairs that significantly increase their value or prolong their life. The basis of machinery and equipment is recovered through depreciation allowances as discussed later in this chapter.

#### **Reforestation Tax Incentives**

Qualified reforestation expenditures (or afforestation, in the case of planting or seeding non-forest land) paid or incurred in a tax year, to a maximum of \$10,000, are eligible for a 10 percent investment tax credit (an offset against taxes owed) and for amortization (deduction) over eight tax years. The annual limit is \$5,000 in the case of a married individual filing a separate return. This favorable treatment was provided by Public Law 96-451, which was codified in Sections 194 and 48 of the Internal Revenue Code. It is an exception to the general rule that reforestation costs, which must be capitalized, are recoverable only when the timber is sold, cut, or otherwise disposed of. Qualified reforestation costs are the direct expenses incurred in establishing a stand of timber—whether by planting, seeding, or natural regeneration as discussed above.

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The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

- Recordkeeping . . . . . 37 hr., 4 min.
- Learning about the law or the form . . . . . 35 min.
- Preparing and sending the form to the IRS . . . . . 1 hr., 14 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the IRS. See the instructions for the tax return with which this form is filed.

**General Instructions**

Section references are to the Internal Revenue Code unless otherwise noted.

**Who must file.**—If you claim a deduction for depletion of timber or for depreciation of plant and other improvements related to timber accounts, or elect under section 631(a) to treat the cutting of timber as a sale or exchange, you must complete and attach Form T to your income tax return. Generally, you should file Form T when you sell or cut standing timber or are involved in other timber transactions.

Complete Form T in accordance with sections 611, 631, and 1231 and related regulations. **Complete only Schedules C and F if you are a small-woodlot owner whose only timber-related activity during the year was an isolated sale of timber.**

**Overview of form.**—Form T has nine schedules. Use the following rules to determine which schedules to complete.

**Schedule A (optional).**—If you do not send the Schedule A maps in with Form T, you must make them available if your return is examined.

**Schedule B.**—Complete for any year you acquire timber, timber cutting contracts, or forest land. Complete Schedule B

whether the acquisition is a purchase, exchange, gift, or inheritance.

**Schedule C.**—Complete for any year you sell or exchange timber, timber cutting contracts, or forest land.

**Schedule D.**—Complete if you claim a loss on your income tax return for timber lost due to fire, wind, theft, or other causes.

**Schedule E.**—Complete only if you pay or incur expenses for reforestation of forest land or for timber stand activities. Examples of reforestation expenses are costs for site preparation and for planting or seeding. Examples of timber stand activities are precommercial thinning and fertilization.

**Schedule F.**—Complete for each timber account that has changed in quantity or dollar amount. A timber account may change in quantity or dollar amount as a result of acquisitions, dispositions, the cutting of timber, capitalized expenditures, casualty or theft losses, corrections, additions for growth, and transfers from other accounts. Use Schedule F to figure depletion for timber cut or the basis for timber sold or lost during the tax year. Also use Schedule F if you treat the cutting of timber as a sale or exchange under section 631(a).

**Schedule G.**—Complete to show changes in ownership of land during the tax year.

**Schedule H (optional).**—Complete if you incur expenses for the building of logging truck roads. If a timber company builds the road but later charges the landowner for the cost, the landowner should complete Schedule H.

**Schedule I (optional).**—Complete if you incur expenses for building drainage structures, such as ditches.

For more information about Federal income tax rules and recordkeeping for forestry activities, see *Agriculture Handbook No. 681, Forest Owners' Guide To Timber Investments, The Federal Income Tax, and Tax Recordkeeping*. To order this handbook, call 202-512-1800 (not a toll-free number) or write the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402. The handbook costs \$7.00 (subject to change); its GPO stock number is 001-000-04540-7.

**Schedule A Maps (Optional)**

1 This schedule consists of a map (or maps) of your timber properties. Whether you file the maps with your income tax return is your option, but you must make them available if your return is examined. Maps of convenient size are desirable, varying in scale from approximately 4 inches to the mile in small tracts to 1/2 inch to the mile in tracts larger than 200,000 acres. The maps should show your name and the tax year. Give standard map symbols in

enough detail to show clearly the location of: (a) timber cutting contracts acquired separately from the land; (b) forest lands acquired; (c) areas where you cut timber; (d) timber sold or otherwise disposed of under cutting contracts; (e) forest land sold or otherwise disposed of; and (f) forest land sold or otherwise disposed of with the timber cutting rights reserved to you or outstanding in third parties.

**Schedule B Acquisitions**

2 Report acquisitions during the tax year (such as by purchase, exchange (whether taxable or not), gift, or inheritance) of timber, timber cutting contracts, or forest land. Report separately each acquisition of \$10,000 or more. You may combine acquisitions of less than \$10,000 for each account, and omit lines 4 and 5. For an acquisition by gift or inheritance, do not complete line 6 through 8b. For an acquisition or lease of timber-cutting rights on a

pay-as-cut basis, except for those under which all cutting is completed within the tax year, do not complete lines 6 through 10. Instead, briefly give the provisions of the purchase or lease agreement, including the number of years from the effective date to the expiration date, annual minimum cut or payment, and the payment rates for different kinds of timber and forest products. Follow the format of lines 3 through 10 on additional sheets if necessary.

3 Name of block and title of account <sup>1</sup> (Your Name) Timber Account

4 Location of property (by legal subdivisions or map surveys) W 1/2 of NE 1/4 of S. 5 & W 1/2 of SE 1/4 of NE 1/4 of S 5, Spring Township, Pine County, Alabama

<sup>1</sup>You must include your timber in one or more accounts. Generally, each account must include all your timber that is located in one "block." A block may be (a) an operational unit that includes all timber that would logically go to a single point of manufacture, (b) a logging unit that includes all timber that would logically be removed by a single logging development, or (c) an area established by the geographical or political boundaries of logical management areas. Timber acquired under a cutting contract may not be included in part of a block, but should be kept in separate accounts. For exceptional cases, the timber in a given block may be divided into two or more accounts. See Regulations section 1.611-3(d) for more information.



**Schedule E Reforestation and Timber Stand Activities**

26 Summarize your expenses for reforestation and timber stand activities on this schedule. Keep detailed information to support the costs reported in this schedule and make it available if your return is examined. Report on Schedule E expenses such as supplies, labor, overhead, transportation, tools, and depreciation on equipment.

**Site preparation.**—Report all expenses incurred during the tax year for preparing the land for planting or seeding (including natural seeding). Include expenses for clearing the land of brush and cull trees by burning, disking, chopping, shearing and piling, spraying with herbicides, or other measures taken to aid successful site reforestation. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work.

**Planting or seeding.**—Report the expenses you incurred during the tax year for planting seedlings or sowing seed to reforest the land. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work.

**Precommercial thinning or fertilization.**—Report all expenditures that must be capitalized and items that you elect to capitalize. Also, list on a separate attachment items that are currently deductible. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work.

Account, block, tract, or area	Kind of activity (burning, chopping, spraying, planting, seeding, thinning, pruning, fertilizing, etc.)	Number of acres treated	Total expenditures
Total.			

**Schedule F Capital Returnable Through Depletion**

On lines 27 through 42, give the data for each timber account separately. Cover any changes that have taken place during the tax year. Attach as many additional pages of this schedule as needed. If you deplete on the block basis, combine new

purchases with the opening balances and use the average depletion rate shown on line 34 for all timber cut or sold, regardless of how long held. If you express timber quantity in MBF, log scale, name the log rule used ▶

27 Name of block and title of account ▶	(a) Quantity in MBF, log scale: cords: or other unit <sup>1</sup>	(b) Cost or other basis
28 Estimated quantity of timber and amount of capital returnable through depletion at end of the immediately preceding tax year.	1,000 Cords	28,274.00
29 Increase or decrease of quantity of timber required by way of correction <sup>2</sup>	200 Cords	
30a Addition for growth (period covered ▶ ..... years)	80 Cords	2,173.00
b Transfers from premerchantable timber account		
c Transfers from deferred reforestation account		
31 Timber acquired during year		
32 Addition to capital during year <sup>3</sup>		
33 Total at end of year, before depletion (add lines 28 through 32, in each column)	1,280 Cords	30,447.00
34 Unit rate returnable through depletion, or basis of sales or losses (line 33, column (b), divided by line 33, column (a))		
35 Quantity of timber cut during year		
36 Depletion sustained (line 34 multiplied by line 35)		
37 Quantity of standing timber sold or otherwise disposed of during year		
38 Allowable as basis of sale (line 34 multiplied by line 37)		
39 Quantity of standing timber lost by fire or other cause during year		
40 Allowable basis of loss (line 34 multiplied by line 39)		
41 Total reductions during year:		
a Add line 35, column (a); line 37, column (a); and line 39, column (a).		
b Add line 36, column (b); line 38, column (b); and line 40, column (b).		
42 Net quantity and value at end of year (line 33, column (a) less line 41a, column (a); and line 33, column (b) less line 41b, column (b)).	1,280 Cords	30,447.00

<sup>1</sup>If MBF, log scale, is not the unit used, state what unit you used and explain it.

<sup>2</sup>Adjust the quantity in MBF, log scale, or other unit remaining at the end of the year for changes in reinventory, standards of use, scattered and/or indefinitely ascertained losses, inaccuracy of the former estimate, or change in the log scale if the log rule now in use differs from the one used as basis for depletion in earlier years. If you make a change, clearly state the basis for it.

<sup>3</sup>Analyze the addition to show the individual items included. Include expenditures for taxes, administration, protection, interest actually paid, etc., if you did not treat these expenditures as expense deductions on your return. Carry expenditures for reforestation, such as site preparation, planting, seeding, etc., in a separate deferred account.

43 Quantity of cut timber that was sold as logs or other rough products

Figure V-2. Schedule F of Form T (Timber)

**Schedule F Capital Returnable Through Depletion (Continued)**

44 Are you electing, or have you made an election in a prior tax year that is in effect, to report gain or loss from the cutting of timber in accordance with section 631(a)? (This election is binding for all eligible timber cut in the election year and all subsequent years. You may revoke the election only with IRS consent, unless you made the election for a tax year beginning before 1987.)  Yes  No

If "Yes," furnish the information asked for in items 45 through 51.

45 Gain or loss on standing timber as reported on Form 4797, Sales of Business Property. Show the adjusted basis for depletion and the fair market value, by species and unit rates if reported on a species basis. Section 631(a) requires you to determine the fair market value of timber cut during the year for timber you owned, or held under contract right to cut, for more than 1 year. The fair market value is the value of the timber as it stood in the forest on the first day of the tax year.

46 Furnish the date of acquisition of timber that was cut in the tax year, if acquired after March 1, 1913; the quantity of timber remaining (adjusted for growth, correction of estimates, changes in use, and any change in the log rule used); and the adjusted basis at the beginning of the tax year. State the acreage cut over and the amount of timber cut from it during the tax year and the log rule or other method you used to determine the quantity of timber cut. If you kept depletion accounts by separate tracts or purchases, give the information separately for each tract or timber purchase.

If you used an average depletion rate based on the average value or cost of a timber block in earlier years, the adjusted basis referred to in section 631(a) is the average basis shown on lines 34, after adjustment.

47 Describe in detail the characteristics of the timber that affect its value, such as total quantity, species, quality, quantity per acre, size of the average tree, logging conditions, distance to markets, and the like.

48 Give evidence in the form of actual sales of comparable timber as of the valuation date, along with other value evidence used. Include a computation showing the difference between the cost (excluding timber or stumpage cost) and value of the primary wood product (logs or other roundwood, chips, etc.) at the mill or plant. Give detailed evidence that permits a comparison with the timber on which you report a value.

49 For all purchases and sales of timber you make, and for all other transactions you report, furnish the relevant information from lines 2 through 20.

- 50 Furnish the following additional information:
- a. Location of the sawmill, log market, or other point of delivery of the logs or wood to the user or buyer.
  - b. The total MBF, log scale, cords, or other units of timber cut, and the length and diameter of the average log or the average number of units per tree.
  - c. The percentage of rough lumber grades, by species, manufactured from the timber during the year; or, if cut timber is sold as logs, the percentage of log grades, by species.

51 Section 631(a) applies only to timber owned, or held under a contract right to cut, for a period of more than 1 year. In your records show the quantity of timber cut that you held for more than 1 year. Show separately the quantity of timber cut that was held for less than 1 year. Also, the scale of logs purchased during the year must be shown by species and quantity and excluded from the quantity shown as cut under section 631(a). Records must also show the number, cost, and point of delivery of purchased logs by species and grade.

**Schedule G Land Ownership**

52 Show changes in land accounts as carried on your books. Attach as many additional sheets as you need, following the format of lines 53 through 58.

53 Name of block and title of account ▶	Acres	Total cost or other basis. Give amount of March 1, 1913, appreciation, if included	Average rate per acre
54 Balance at beginning of year			
55 Acquisitions during year			
56 Sales during year			
57 Other changes			
58 Balance at end of year (add lines 54 and 55, less lines 56 and 57)			

**Optional Schedules**

If the supporting statements for Schedules H and I are too numerous to file with your return, keep this information and make it available if your return is examined. Include separate cost accounts for construction by you and by the contractor.

**Schedule H Road Construction Cost**

Report on lines 61 and 62 the expenditures incurred for road construction during the tax year. Use a separate schedule for each depletion account, block, tract, or geographic area tributary to a mill or mill complex.

Roads constructed on lands owned in fee:	
Miles constructed ▶	
Amount capitalized to nondepreciable account	
Amount placed in depreciation account	
Amount claimed as an ordinary expense	
Total amount spent (add lines 61b through 61d)	
Roads constructed for logging timber held under leases or cutting contracts having a term of 2 years or longer:	
Miles constructed ▶	
Amount to be amortized	
Amount claimed as an ordinary expense	
Total amount spent (add lines 62b and 62c)	

As an alternative, for those engaged in the business of farming, some or all of Conservation Reserve Program (CRP) expenses for tree planting may be deducted annually under Code Section 175. This section provides that certain soil and water conservation expenditures may be deducted that would otherwise have to be capitalized. In order to qualify, the expenditures must be consistent with a plan approved by the USDA Natural Resources Conservation Service office for the area where the land is located, or by a comparable State agency. The limit on the amount that can be deducted in any one year is 25 percent of the taxpayer's gross income from farming during that year.

Expenditures for timber stand improvement (TSI) practices in established stands do not qualify for the amortization and tax credit. However, they generally are for maintenance of the stand and, thus, are eligible for deduction as a current expense, subject to the passive activity loss rules, as discussed later in this chapter. Alternatively, they may be capitalized and deducted when the timber is cut, sold, or otherwise disposed of.

Individuals, estates, partnerships, and corporations are eligible for either or both the amortization and credit. Trusts are not eligible for either one. The \$10,000 annual limit applies to both the partnership and to each partner, and, in the case of an S corporation (see Chapter XI), to both the corporation and each shareholder. Thus, a partner's or shareholder's total annual reforestation expenditure from all sources eligible for the amortization and credit cannot exceed \$10,000.

To qualify for the reforestation amortization and credit, the reforested or afforested property must be at least one acre in size and be located in the United States. The site must be held by the taxpayer for planting, cultivating, caring for, and cutting of trees for sale or for use in producing commercial timber products. Both owned and leased property qualify.

Christmas tree establishment expenditures do not qualify for either the credit or the amortization. The costs of planting trees in shelterbelts and windbreaks, and of trees planted primarily for nut production and as ornamentals, also do not qualify.

Reforestation expenditures eligible for the amortization and credit do not include those reimbursed under a public cost-share program unless the reimbursed amount is included in taxable income by the recipient. If the cost-share payment is recorded as income, the total reforestation cost (including the cost-share payment), subject to the \$10,000 annual limitation, qualifies for both the amortization and the tax credit. Reforestation costs incurred under the CRP program, including the cost-share payments received, are eligible for the amortization and credit if not deducted as discussed above. CRP cost-share payments are always reportable as income; they are never eligible for exclusion. The tax treatment of cost-share payments is discussed on page 40.

## Amortization

Amortization of reforestation expenditures must be specifically elected in writing. It is extremely important that this is done on a timely filed return, including extensions, for the tax year in which the expenditures are made. The election cannot be made on an amended return. Once the election is made, however, missed amortization deductions can be taken on amended returns. To make this election, you should attach Form 4562 to your income tax return and enter the required information and the deduction in Part VI, which concerns amortization. Also attach to the form, on a plain sheet of paper, a statement giving the amount of the expenditure, the nature of the expenditure, the date incurred, the type of timber being grown, and the purpose for which the timber is being grown. A separate statement must be included for each property for which reforestation expenditures are being amortized.

The amortizable basis of reforestation investments must be reduced by 50 percent of the investment tax credit taken. Thus, if the 10 percent tax credit is taken (discussed in a later paragraph), only 95 percent of the eligible reforestation expenditure (a maximum of \$9,500 per year) may be amortized. The amount attributable to the 5 percent reduction is permanently lost—it may not be capitalized to be recovered later when the trees are cut or sold. A half-year convention applies to amortization deductions. This means that only 1/14th of the eligible cost can be deducted the first year. One-seventh is deducted in each of years 2 through 7, and the remaining 1/14th in the eighth tax year. There is no carryover to subsequent years of expenditures in excess of \$10,000 per year. These amounts remain in the reforestation or young growth capital accounts for later transfer to a merchantable timber account. Eventually they may be recovered when the trees are sold or otherwise disposed of.

The form on which to report the deduction depends on the status of the taxpayer. For those who report as investors rather than as a business, the deduction is shown on the line for adjustments to income on the bottom of the front page of Form 1040 by writing "reforestation" and the amount of the deduction on that line. This amount is included in total adjustments to income. It is not necessary to list the amortization deduction as an itemized deduction on Schedule A. For those taxpayers whose timber holdings are treated as a business (see Chapters IV and XI), the amortization deduction is taken on the "other expenses" line of page 1 of Schedule C and explained on page 2. For farmers, it is taken on the "other expenses" line of Schedule F. If reforestation expenditures are incurred in more than one year, a separate schedule must be maintained for each year and reported on Form 4562 according to the instructions.

If the trees are disposed of within 10 years, all of the taxes saved by amortization deductions claimed are subject to recapture as ordinary income (to the extent of any gain realized from the disposal). There is no recapture, however, if the property is disposed of by gift, and generally recapture may not occur with respect to transfer at death, like-kind exchange, involuntary conversion, and certain tax-free transfers such as a transfer to a corporation you control.

## The Credit

The investment tax credit is reported in Part I of IRS Form 3468. Any unused credit may be carried back to tax returns for the three preceding years and then forward for 15 years until used. If the trees are disposed of before 5 years, part or all of the credit is subject to recapture on Form 4255. The only exception is for transfers at death. The recapture percentage is 100 percent during the first full year after seeding or planting; it then decreases by 20 percentage points every succeeding full year. No credit is recaptured after the fifth full year. For additional information, see the instructions for Form 4255, "Recapture of Investment Credit."

Example V-3 shows how to claim the reforestation amortization and credit.

### Example V-3

**Reforestation amortization and credit:** Assume you reforested 120 acres during the tax year at a cost of \$100 per acre, resulting in a total cost of \$12,000. You receive no cost-share payments.

When you file your income tax return for that tax year, you can take the tax credit on \$10,000 of the reforestation expense and amortize \$9,500 of it—the maximum amount of expenditure that qualifies in any one year. The remaining \$2,000 must be capitalized to the plantation subaccount.

The amortization would be elected as explained earlier. The amount amortized is \$9,500—the \$10,000 allowable reforestation expense less half of the \$1,000 tax credit. Under this option, \$679 (1/14th of the \$9,500 allowable cost) is amortized in the first year. During each of the next 6 years, \$1,357 or 1/7th of the cost would be deducted, and the remaining \$679 would be deducted in the eighth year. The investment tax credit of \$1,000 is claimed on Form 3468.

## The Section 179 Deduction and Depreciation

Timber producers often have large investments in machinery and equipment, and in land improvements such as bridges, fences, and buildings. The Internal Revenue Code allows you to take annual depreciation deductions on such property that is either used in a business or held for the production of income (as an investment); has a determinable useful life; and wears out, decays, gets used up, becomes obsolete, or loses value from natural causes. This section briefly explains major changes made by the 1986 Tax Reform Act, and other changes in the Federal income tax law since 1987, in the way depreciation is calculated. The basic rules are summarized to give an overview to timber owners and operators for tax planning purposes. The fine points and exceptions to the rules are omitted because of space limitations. You should consult IRS publication No. 534 or your accountant for additional information on specific problems.

### Section 179 Deduction

You may be able to deduct immediately as an expense up to \$17,500 per year of the cost of qualifying depreciable

personal property associated with or used in your timber operation if the operation qualifies as an active trade or business. This option is called the Section 179 deduction. You must elect to take the deduction on the first income tax return for the tax year in which the property is placed in service (whether or not the return is timely) or on an amended return filed within the time prescribed by law (including extensions) for filing the return for such tax year. Otherwise, the Section 179 election cannot be made on an amended return. An estate or trust cannot make the Section 179 election. If you elect the deduction, you must specify the part of the cost of each item you elect to deduct. The amount of the Section 179 deduction is subtracted from the basis of the property concerned before computing depreciation. You report the Section 179 deduction on Form 4562.

The \$17,500 deduction is reduced one dollar for each dollar of investment over \$200,000 during the tax year in question in Section 179 property. Thus, if you place \$208,000 of qualified property in service in a particular tax year, only \$9,500 (\$17,500 - \$8,000) qualifies for the deduction. The deduction is also limited to the amount of aggregate taxable income (computed without subtracting the Section 179 deduction) attributable to your active conduct of trades or businesses. Depreciable investment property or property held for personal use does not qualify. The amount of eligible cost that is not deductible in one tax year because of insufficient active trade or business income may be carried forward indefinitely to later years until it can be deducted (see Example V-4).

### Example V-4

**Section 179 deduction:** Assume you invest \$7,000 in a used truck and \$20,000 in a used tractor, both for your timber business. You have \$9,000 of aggregate taxable active business income for the tax year in question. You may elect on Form 4562 to expense under Section 179 for the \$7,000 cost of the truck, and \$10,500 of the cost of the tractor for a total of \$17,500 (or you could elect all \$17,500 on the tractor). Your total deduction for the tax year is limited to the \$9,000 of aggregate active trade or business income. The \$8,500 difference between the \$9,000 taxable income limit and the \$17,500 maximum dollar limit may be carried forward to future tax years until used up.

The net benefit from the Section 179 deduction must be recaptured if the property in question is not used in an active trade or business more than 50 percent of the time in any tax year before the property's recovery (depreciation) period expires. Recapture of the Section 179 deduction is reported on Form 4797.

## Depreciation

You, as a forest owner, may depreciate most property used on your woodland if you hold your woodland as either a business or as an investment. Property acquired either new or used may be depreciated. Land is never depreciable, but certain improvements to land such as fences, temporary roads, bridges, and buildings are depreciable. To claim depreciation, you use the Modified Accelerated Cost

Recovery System (MACRS) established by the 1986 Tax Reform Act for most tangible property placed in service after 1986. You cannot change to MACRS for property placed in service prior to 1987 that is being depreciated under another method such as the Accelerated Cost Recovery System (ACRS). Under MACRS, property is assigned a class life that determines the depreciation recovery period. The recovery periods for property under the General Depreciation System of Section 168 of the Internal Revenue Code are 3, 5, 7, 10, 15, and 20 years. For residential real property, the period is 27.5 years, and for nonresidential real property, the recovery period is 39 years. If the property was placed in service before May 13, 1993, the recovery period is 31.5 years. Table V-1 shows the recovery periods for certain types of property typically associated with woodland operations.

Under MACRS, 3-, 5-, 7-, and 10-year properties are depreciated in the beginning years using the 200 percent declining balance method, and 15- and 20-year properties are depreciated in the beginning years using the 150 percent declining balance method. Depreciation is determined by the straight line method starting in the tax year when it maximizes the depreciation allowance. Under MACRS, you may also, in certain circumstances, calculate depreciation using the straight line method. You may elect to exclude certain timber-related property, such as temporary logging roads, from MACRS and depreciate it under the unit-of-production method or any method of depreciation not expressed in a term of years. With this method, a timber owner depreciates the property based on the number of units of timber harvested in a tax year as compared to the total number of units to be harvested over the life of the property. An example is a logging road constructed solely for use in harvesting specified timber and which on completion of harvesting will no longer be useful to the timber owner.

Section 168 of the Internal Revenue Code prescribes the applicable conventions (half-year, mid-quarter, and mid-month) to be used in computing depreciation deductions for the tax year in which MACRS property is placed in service and the tax year in which the property is disposed of or retired from service. Under the half-year convention, property (other than residential rental property and nonresidential real property) placed in service, disposed of, or retired at any time during the tax year is treated as being placed in service, disposed of, or retired on the mid-point of such year. Under this convention, a half-year of depreciation is allowable for the first year eligible property is placed in service regardless of when the property is actually placed in service during that year. If the aggregate basis of this depreciable property placed in service in the last 3 months of the tax year exceeds 40 percent of the aggregate bases of all such property placed in service during the tax year, the applicable convention for this property is the mid-quarter convention. Under the mid-quarter convention, all property placed in service, or disposed of, during any quarter of a tax year, generally is treated as being placed in service or disposed of on the mid-point of the quarter. The allowable depreciation is a percentage of the depreciation for a full year; for property placed in service in the first quarter of the tax year, 87.5 percent; in the second quarter, 62.5 percent; in the third quarter, 37.5 percent; and in the fourth quarter, 12.5 percent.

The applicable convention for residential rental property and nonresidential real property is the mid-month convention. Under the mid-month convention, property placed in service, or disposed of, during any month of a tax year, is treated as being placed in service, or disposed of, on the mid-point of that month. Thus, regardless of when during the month a taxpayer places residential rental property or nonresidential

**Table V-1—Recovery Periods by Type of Property Under the General Depreciation System of Section 168 of the Internal Revenue Code**

MACRS <sup>1</sup> Recovery Period (Years)	Type of Property
3	Over-the-road (semi-) tractors
5	Automobiles and pickup trucks; logging machinery and equipment and road-building equipment used by logging and sawmill operators and pulp manufacturers for their own account.
7	Farm machinery and equipment such as tractors and planting machines, and farm fences. Before 1989, single purpose agricultural or horticultural structures; after 1988, these single purpose structures are 10-year property. Also, any property that does not have a class life and is not otherwise classified under Sections 168(e)(2) or (3).
10	Property with a class life of 16 years or more, but less than 20 years.
15	Land improvements such as bridges, culverts, and nonfarm fences.
20	Farm buildings (except single purpose agricultural or horticultural structures).
27.5	Residential rental property.
31.5	Nonresidential real property placed in service before May 13, 1993.
39	Nonresidential real property placed in service after May 12, 1993.

<sup>1</sup> Modified Accelerated Cost Recovery System

### Example V-5

A timberland owner spent \$20,000 for a multi-purpose machine shed which he placed in service in July 1994. He additionally purchased and placed in service in his business a \$60,000 used over-the-road tractor in September and a \$30,000 used rubber-tired skidder in October. No other depreciable property was placed in service by him in 1994. He also spent \$12,000 in December to plant seedlings on 100 acres of his timberland. He is on a calendar-year tax basis.

Since not more than 40 percent of the value of personal property purchased during the year (tractor and skidder) was placed in service in the last quarter of the tax year of this calendar-year taxpayer, the half-year convention applies as follows:

Section 179 deduction (he elects to deduct part of the skidder's cost)	\$ 17,500
MACRS deduction on the over-the-road tractor (3-year property) \$60,000/3 years x 200% x 1/2 year	\$ 20,000
MACRS deduction on the skidder (5-year property) (\$30,000 - \$17,500 Sec. 179)/5 years x 200% x 1/2 year	\$ 2,500
MACRS deduction on the machine shed (39-year property) \$20,000 divided by 39 years x (5.5/12 months)	\$ 235
Total Section 179 and depreciation deductions	\$40,235
Reforestation amortization: \$9,500/7 years x 1/2 year (\$9,500 = \$10,000 - 1/2 of tax credit)	\$ 679
Total deductions	\$40,914
Reforestation tax credit: 10% x \$10,000 limit	\$ 1,000

If the over-the-road tractor had been placed in service in October, then more than 40 percent of the value of the personal property would have been placed in service in the last quarter of the tax year, and the mid-quarter convention would apply to the personal property as follows:

MACRS deduction on tractor (\$60,000/3 years x 200% x 12.5%)	\$ 5,000
MACRS deduction on skidder (\$30,000 - \$17,500)/5 years x 200% x 12.5%	\$ 625
Total deductions on tractor and skidder	\$ 5,625

real property in service, the property is deemed to be placed in service on the mid-point of the month.

This example illustrates the importance of planning purchases. By purchasing and placing the tractor in service in September before the last quarter, \$40,235 of the cost of the equipment was deductible in 1994 compared to \$23,360 (=17,500+5,625+235) if all of the personal property were purchased and placed in service in the last quarter of the tax year.

### Operating Expenses and Carrying Charges

Timber owners commonly incur costs associated with the day-to-day management of their forest property. Such expenditures include, but are not limited to, fees paid to consulting foresters; travel expenses directly related to the income potential of the property; the costs of silvicultural activities such as prescribed burning and precommercial thinning; the expenses of fire, insect, and disease control and protection; the costs of tools having a short, useful life; salaries for hired labor; road and fire break maintenance costs; and professional fees. These types of expenditures are commonly called timber operating costs. Woodland owners also generally incur expenses for property taxes and perhaps for interest and insurance. Such costs, together with certain other expenses related to the development and operation of timber properties, are termed "carrying charges."

Operating costs and carrying charges that are considered to be "ordinary and necessary" expenses of managing, maintaining, and conserving forestland may be wholly or partially

deducted (expensed) each year as incurred, even if the property is currently producing no income—provided that the timber growing activity is being engaged in for profit and the expenditures are directly related to the income potential of the property. A presumption that an activity is being carried on for profit applies if there has been net income from the property (profit) in at least three of the five consecutive years ending with the current year. If this test cannot be met, however, deductions are not automatically denied. Rather, all facts and circumstances of the situation are considered in determining whether or not a profit motive exists. The term "profit" includes appreciation in the value of assets. This principle is particularly relevant in the case of timber, which is unique property in that its appreciation in value—contrary to most other assets—is due primarily to physical growth and enhanced quality over a long period of time. Although there is often no net income from forest properties for many years, the intent of most owners is to achieve an overall profit once the increase in timber value is realized.

As an alternative to currently deducting timber-related expenditures, you may elect to capitalize them if you so choose. Strictly speaking, only carrying charges may be capitalized. Carrying charges are taxes, interest, and certain other expenses related to the development and operation of timber properties that may be treated as either deductible expenses or capital costs. As a practical matter, however, many other deductible timber-related costs are considered to be carrying charges. Capitalized carrying charges are added to the timber's basis and are recovered by offsetting gain realized upon the sale or cutting of timber, as discussed on page 31.

Although the regulations governing the capitalization of carrying charges do not specifically address timber-related costs, they do set forth general rules that are applicable to the capitalization of timber expenditures. They provide that in the case of "unimproved and unproductive real property," taxpayers may elect—on a year-to-year basis—to capitalize "annual taxes, mortgage interest, and other carrying charges." Unimproved real property is generally defined as land without buildings, structures, or any other improvements that contribute significantly to its value. Forest land is unproductive in any year in which no income is produced from its use—such as from hunting leases, timber sales, or sale of products cut from timber. You may not capitalize carrying charges incurred in any year your property is productive.

The regulations additionally provide with respect to real property "whether improved or unimproved, and whether productive or unproductive," that taxpayers may elect to capitalize necessary expenditures associated with development of the property up to the time the development is completed. Once made, however, the election to capitalize "development-related expenditures" continues in effect until development has been completed. Costs incurred for silvicultural treatments in established stands—such as precommercial thinning and other timber stand improvement (maintenance) work—fall into this category. This means that such costs may be capitalized to the timber account if you do it consistently from year to year.

You elect to capitalize by filing with your original tax return for the year for which the election is to be effective a written statement on a plain piece of paper indicating the cost items you are capitalizing. The election cannot be made on an amended return.

### The Passive Loss Rules

The extent to which operating costs and carrying charges are currently deductible depends on how you are classified under the 1986 Tax Reform Act with respect to ownership and operation of your forest property. This legislation made a number of significant changes related to deductions that are set forth in what are called the "passive loss rules."

The passive loss rules govern the extent to which an operating loss from a particular activity for any given tax year can be offset against income from other sources. The passive loss rules apply to individuals, estates, trusts, and to two categories of corporations: "personal service corporations" (those whose principal activity is the performance of personal services that are substantially performed by employee-owners) and "closely held C corporations" (those that are subject to the corporate income tax and in which more than 50 percent of the value of the stock is owned by five or fewer individuals). Except for these two types of corporations, the passive loss rules do not apply to corporations generally. The passive loss rules also do not apply directly to partnerships and Subchapter S corporations since they are essentially "flow-through" entities that are not taxed in their own right. However, the rules do apply to deductions passed through from partnerships and Subchapter S corporations.

If your timber ownership is subject to the passive loss rules, you must determine which of the following three classifications applies to you and your forest property. This determination must be made for each tax year. The rules for deducting operating costs and carrying charges vary, depending on which of these categories your timber activity fits. The three categories are as follows:

- (1) timber held as part of a trade or business in which you materially participate;
- (2) timber held as part of a trade or business in which you do not materially participate (that is, a passive activity); and
- (3) timber held for the production of income (that is, as an investment), but which is not part of a trade or business.

### Timber Held as Part of a Trade or Business in Which the Taxpayer Materially Participates

In this situation, all operating expenses and carrying charges related to the timber activity are fully deductible against income from any source each year as incurred. Credits arising from the timber activity (such as the reforestation tax credit discussed on page 25) can also be applied to taxes associated with income from any source. If your total deductions from your trade or business activities (including your forest property) exceed your gross income from all sources for the tax year, the excess will be a "net operating loss." This loss generally may be carried back to the 3 preceding tax years, and if still unused, then be carried forward to the next succeeding 15 tax years.

**Material Participation**—The law provides that to be "materially participating," a taxpayer must be involved in operations with respect to the property on a basis that is "regular, continuous, and substantial." Both you and your spouse will be treated as one taxpayer for purposes of determining whether the material participation requirement has been met. It does not matter whether your spouse owns an interest in the property or not, or whether you file joint or separate tax returns.

According to temporary regulations issued by the Internal Revenue Service, you will be considered to be materially participating in the operation of your timber activity if you meet at least one of the following tests:

- (1) You and your spouse participate in the activity for more than 500 hours during the tax year.
- (2) You and your spouse's personal participation in the activity constitutes substantially all of the participation (including that of all other individuals) for the tax year.
- (3) You and your spouse participate in the activity for more than 100 hours during the tax year and no other individual participates more.
- (4) You and your spouse's aggregate participation in all of your "significant participation activities," including your timber activity, exceeds 500 hours during the tax year. An activity is a "significant participation activity" if it is a trade or business in which you participate for more than 100 hours during the tax year. Thus, you could qualify under this test even if another individual who co-owns forest property with you participates in its operation more than you do during the tax year in question.
- (5) You and your spouse materially participated in the activity for any of 5 of the preceding 10 tax years. For this purpose, material participation in pre-1987 tax years is

counted. However, you must meet the 500-hour test to qualify in any of those years.

- (6) If all the facts and circumstances of the situation indicated that you and your spouse participated in the activity on a regular, continuous, and substantial basis during the tax year. The specific rules to be followed in applying this test have not been issued by the Internal Revenue Service at this writing. However, several general principles may currently be used as guides. The first is that your management of the timber activity isn't taken into account if a paid manager participates in its management or if your management services are exceeded by those performed by any other individual. And second, if you don't participate in the timber activity for more than 100 hours during the tax year, you cannot satisfy the facts and circumstances test for the year.

Formal recordkeeping is not required to prove the number of hours you devote to operation of your timber activity. You are allowed to document the number of hours by any reasonable means, including—but not limited to—appointment books, calendars, and narrative summaries.

**Surviving Spouses**—In some cases, surviving spouses of retired or disabled persons may not be subject to the material participation tests. If the timber ownership qualifies as a farm business under Section 2032A of the Internal Revenue Code (relating to estate tax special use valuation of farm and forestland), such persons need only satisfy an "active management" test. This test involves no specified number of hours nor does it impose restrictions on participation by other persons. Rather, the taxpayer need only be involved in making major management decisions and not day-to-day operating decisions.

**Reporting Expenses**—If your timber operations are incidental to farming activities, list your deductible timber expenses together with your deductible farming expenses on Schedule F of Form 1040, "Farm Income and Expenses." There are separate lines for tax and interest deductions. Timber operating costs and carrying charges for which there are no specific line entries should be itemized on the line for "other expenses." All such deductions should be individually listed.

If your timber operations are a separate business, or are incidental to a nonfarm business, report your timber deductions on Schedule C of Form 1040, "Profit or (Loss) from Business or Profession." There are also separate lines on Schedule C for tax, interest, and certain other specific deductions. Other timber-related deductions should be individually listed on the line for "other expenses."

#### **Timber Held as Part of a Trade or Business in Which You Do Not Materially Participate**

The second category is timber held as part of a "trade or business" in which you do not materially participate in one of the ways discussed above. Under the passive loss rules, this type of forest ownership is classified as a "passive activity." C corporations (those subject to the corporate income tax) that are not classified as closely held or as personal service

corporations can currently deduct operating costs and carrying charges associated with passive timber ownership from income from any source without limitation. Generally, deductions attributable to passively held forest properties and other passive activities by taxpayers subject to the passive loss rules are allowed only to the extent of the taxpayer's income from all passive activities during the tax year. An exception to this rule is that closely held C corporations (other than personal service corporations) are permitted to offset deductions from passive activities against income from active businesses (but not against portfolio income, which includes such items as dividends and interest). Credits attributable to passive timber ownership (such as the reforestation tax credit discussed on page 25) may only be applied to offset taxes associated with income from passive activities.

Generally, casualty loss deductions are not subject to the passive loss rules. Such deductions (see Chapter VII) may be taken currently against income from any source by passive taxpayers as well as by those who are material participants.

If your deductions from a passive timber ownership (including depreciation and amortization deductions) exceed your passive income (from all sources) for the tax year, the excess may be carried forward and used in future years when you either realize passive income or else dispose of the entire timber ownership that gave rise to the passive loss. Credits not used during a particular tax year may also be carried forward (but not back) for use in future years, but may not be taken solely because you dispose of your entire ownership interest. In certain cases, you may elect to increase the basis of property by the disallowed credit immediately before the transfer of the property.

For tax reporting, computation of allowable passive deductions for the tax year is calculated on Form 8582, "Passive Activity Loss Limitations." It is beyond the scope of this publication to describe in detail the use of this complex form. If your timber ownership is passive in nature, you may want to consult a professional tax advisor concerning the use of Form 8582.

#### **Timber Held as an Investment**

The third category is timber held as an investment, rather than as part of a trade or business. The distinction between a "trade or business" and an "investment" is not always an easy one to make. All the facts and circumstances relating to the activity have to be examined. In general, however, an investment is an undertaking entered into or engaged in with a view to realizing a profit—but which does not involve the same regularity or frequency of activity that a trade or business would require. Corporations in the investment category can fully deduct operating costs and carrying charges against income from any source. However, as described next, the deductibility of these expenditures by noncorporate investors is generally more limited.

**Management Costs**—Both corporate and noncorporate timber owners may generally deduct management costs relating to timber held as an investment against income from

any source. Management costs, as used here, include all operating costs and carrying charges except property taxes and other deductible taxes, and interest. However, for noncorporate taxpayers, such expenditures are classified as "miscellaneous itemized deductions." This means that they can be deducted only to the extent that, when aggregated with all of your other "miscellaneous itemized deductions," the total exceeds 2 percent of your adjusted gross income. The proportion of such deductions that falls below the 2-percent floor is permanently lost. Other types of "miscellaneous itemized deductions" that you may incur include, but are not limited to, costs of tax return preparation, safe-deposit box rental, financial journal subscriptions, and investment advice. Timber management costs in this category may also be capitalized as carrying charges as discussed on page 27, if you prefer. However, the same expenditure cannot be counted toward the 2-percent floor on "miscellaneous itemized deductions" and also be capitalized.

**Taxes**—Property and other deductible taxes attributable to your timber held as an investment are deductible in full each year against income from any source by both corporate and noncorporate taxpayers. Tax deductions by noncorporate timber investors are not "miscellaneous itemized deductions" and therefore are not subject to the 2-percent floor for such deductions. If you prefer, you may elect to capitalize property taxes and recover them upon sale of the timber rather than deduct them in the year paid. Severance and yield taxes may not be capitalized; however, they may be currently deducted.

**Interest**—Corporate taxpayers may deduct unlimited timber investment interest expense against income from any source. If you are a noncorporate timber investor, however, you may deduct interest expense (from both timber and nontimber sources) only up to net investment income (from all sources)

for the tax year. Net investment income is your investment income less expenses other than interest expense that are directly connected with production of the investment income. (See IRS Publication 550, "Investment Income and Expenses.") Beginning in 1993, investment income generally cannot include capital gains realized from selling investment property. Example V-6 explains how much investment interest expense can be deducted.

#### Example V-6

**Deduction of investment interest expenses:** Suppose you incur \$3,000 of investment interest expense in 1994 but only have \$2,000 of net investment income. You may not deduct the full \$3,000 of interest paid. Rather, you may deduct only \$2,000 (amount of net investment income). Any excess of investment interest expense over net investment income that cannot be deducted in a particular tax year (such as the \$1,000 in this example) may be carried forward indefinitely and be eligible for deduction in any later year in which net investment income—from any investment source—is realized.

As discussed above, you may elect to capitalize all or part of the interest paid, instead of deducting it or carrying it forward, and thus use it to offset income realized from sale of the timber.

**Reporting Expenses**—Your deductible investment expenses are listed on Schedule A of Form 1040 on the appropriate line for each type of deduction. This is possible only if you itemize deductions for the year. If in any tax year you do not itemize deductions, or alternatively do not elect to capitalize these expenses, the costs are lost for tax purposes, and you will not be able to recover them.